BARCLAYS CAPITAL

EMERGING MARKETS RESEARCH
December 2010

THE EMERGING MARKETS QUARTERLY
A CROWDED CONSENSUS

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In money markets, we are observing opportunities to pay rates. In bond markets, we remain long for now, but we are more cautious. In FX, trend appreciation remains more or less intact. In credit, spreads continue to tighten and we see value only in the more exotic names.

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The levels of risk premia across EMEA FX, rates and credit markets are modest. The upside from bullish trades is limited in light of the EMEA-specific risks: the threat of contagion from the periphery of the euro area to CE, alongside elevated (external) borrowing needs.

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In FX, we like the MXN and CLP. In rates, we expect higher-than-priced inflation in Brazil in the next two years. In credit, we think spreads are in good shape to weather the US Treasury drift we are forecasting.

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We expect fundamentals and technicals to remain positive drivers for the asset class in 2011. That said, we expect EM corporates to be ambitious in 2011, with increased capex, a higher likelihood of M&A activity, and continued issuance.

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We expect total EM sovereign hard-currency gross supply of USD71bn in 2011, slightly less than the USD72bn supply in 2010 (Jan-Nov) and the USD76bn in 2009. The net supply dynamics look generally favourable for EM sovereign credit in 2011.

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OVERVIEW

A crowded consensus

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- **The economic and financial backdrop remains supportive of risky assets. Though lacklustre, the global economic recovery continues to look solid to us and should provoke fewer doubts from investors in the months to come. At the same time, monetary policy in the industrial economies remains in depression-fighting mode.**
- **Facing headwinds from global rates markets, EM fixed income should deliver much less spectacular returns in 2011. We expect external debt to return about 4%, outperforming US Treasuries by 400bp or so. EM FX should continue to grind tighter, but returns will likely be limited by challenging valuations in many popular markets and official interventions designed to impede currency appreciation. EM equities and high-yielding bonds with equity-scale risks and returns should outperform in 2011.**
- **We acknowledge that our assessment of the economic and financial backdrop is in line with a fairly widely shared consensus. Consensus opinion is not always wrong. But a broadly shared consensus tends to promote positioning that renders markets vulnerable to disruptive events that fall outside their base case. While we think it is too early to position on the basis of the many risk cases that confront investors, it remains important to 'think the unthinkable' and to look for hedges against tail risks.**

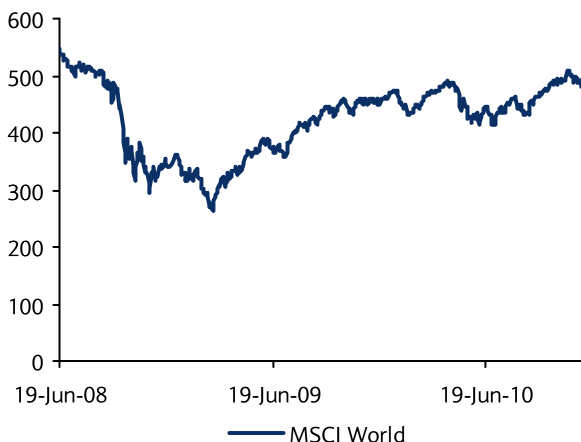
The economic and financial backdrop

What happened

From range trade…

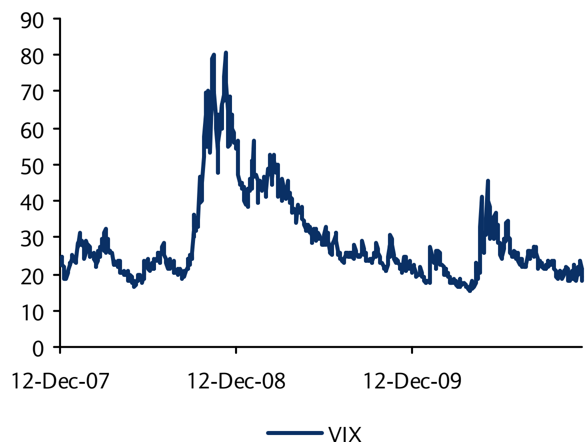
In our June quarterly, and again in September, we suggested that emerging assets would face a global range-trading environment. We expected them to outperform their industrial economy counterparts, but did not think that they would be boosted by an updraft in the global economic and financial markets, as they had already benefitted from the post-crisis asset market boom. Our view was predicated on the assumption that an extended downdraft in asset markets could not be sustained, in light of G3 central banks' determination to avoid one and the Barclays Capital view that the global economic recovery was on solid ground. At the same time, we thought that a lasting bull market would prove hard to sustain, as anxieties about the many risks that coloured the medium-term outlook were likely to remain.

Figure 1: An end to the range trade?



Source: Bloomberg

Figure 2: Equity markets are getting less jumpy



Source: Bloomberg

What we think

…to a more upbeat outlook

Our assessment of the world recovery is largely unchanged, and the longer-term risks that investors face largely remain. But for a couple of reasons, it seems to us that the world now faces a somewhat different immediate financial context, one which favours stronger asset markets in the months to come, but where tail risks to their continued recovery may loom larger as time passes.

Figure 3: Barclays Capital growth forecasts – Small upgrade, moderately above consensus

	Barclays Capital			BarCap vs. Consensus		Q4 vs. Q3 BarCap Forecasts	
	2010	2011	2012	2010	2011	2010	2011
Global	4.9	4.2	4.4	0.3	0.3	0.2	0.1
G10	2.5	2.3	2.7	0.1	0.4	0.1	0.0
EM	7.8	6.4	6.6	0.9	0.6	0.6	0.6
China	10.2	9.3	9.2	0.1	0.2	0.1	0.3
EM Asia ex-China	8.1	6.2	6.8	0.5	-0.1	0.1	0.0
EMEA	4.3	3.9	4.1	0.7	0.9	0.6	0.6
Latin America	6.1	4.3	4.0	0.2	0.1	-0.1	0.0

Source: Consensus Economics, Barclays Capital

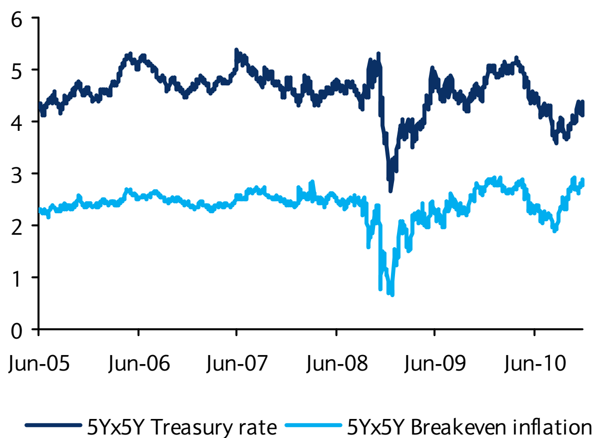
Three key changes

Three things have changed in the past quarter that seem to justify a more optimistic outlook for the next couple of months, at least. The first is that the mid-cycle slowdown that was generating anxieties about the robustness of the US and global economic recovery has proven to be a temporary pause in the recovery.

Firmer macro data in the pipeline

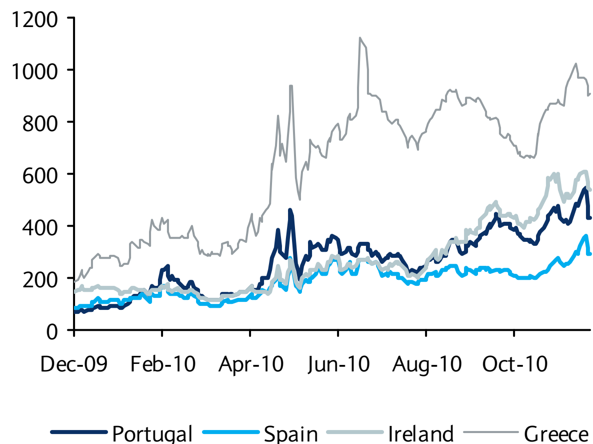
We still expect a recovery in the industrial economies that is lacklustre by the standards of previous ones, but it also looks far less precarious than it had seemed to many investors. Our own forecasts of 2011 GDP growth have increased moderately since our previous quarterly and remain modestly above consensus forecasts. The difference between our view and the consensus is not large enough to drive a strong directional market call. But it gives us some comfort that if the world pans out as we expect it will, markets will do well.

Figure 4: Deflation fears have dissipated (%)



Source: Barclays Capital

Figure 5: Another chapter in the European drama (5y CDS, bp)



Source: Bloomberg

QE2

A second change is the US Fed's decision to engage in another round of quantitative easing, which we did not, when writing our previous quarterly, expect to materialize so quickly. The initial market reaction was a strong rally in US Treasuries, which has since been reversed. The Treasury sell-off was accompanied by a normalization of medium-term inflation expectations (as measured by 5y5y inflation breakevens, Figure 4), which were dropping to abnormally low levels in late summer. The normalization of medium-term inflation expectations suggests that QE2 is making an expectations-driven deflationary cycle less likely, while stronger equity markets since the rally suggest that QE2 is providing the desired support for asset markets.

Another chapter in the European debt drama

Finally, another chapter in the drama in peripheral Europe unfolded in the last months of the year, as Ireland, in response to skeptical markets, requested an EU/IMF package of financial support. However, rather than calming the markets, the announcement led to intensified debt-market weakness and contagion across fiscally vulnerable sovereigns, including Spain, Italy and Belgium. As we write, an ECB announcement that it would continue its program of sovereign bond-buying has calmed European debt markets. But it remains to be seen whether this is merely the eye of the storm or a more permanent turning point. The final chapters of the euro area sovereign debt crisis have yet to be written.

A more benign base case

Stepping back, and assuming for the moment that the European crisis does not intensify in the months to come, the global outlook seems very friendly for risky assets. A combination of plausible valuations in most risk markets, intensive monetary stimulus and dissipating doubts about downside risks to global growth should prove supportive.

But spare a thought for some risks

That is our base case, and on the basis of it, we are recommending that investors prepare for a risk-friendly financial environment in the months to come, both in global markets and specifically in EM, as we will discuss in more detail below. But before we do, let us spare a few thoughts for the many risk cases that confront investors. We do not consider any of these very likely (or we would have a different base case and would be recommending a different investment stance). But if the 2008 financial crisis taught us anything, it is that probability distributions have fatter tails than past experience taught us to believe. Even if none of the following events has a high probability, the probability that at least one of them (or some equally disruptive event that we have not imagined) occurs is not negligible.

1. *A really bad outcome in peripheral Europe*. In a recent Barclays Capital investor poll, many respondents thought that it will be the key theme for financial markets in 2011, second only to "increased concerns about advanced economy fiscal deterioration." But almost no one thought that it would result in "a full-blown crisis with a break-up of the EUR." We, too, consider this highly improbable. But given the inescapable logic of recent market events, and the potential for political backlash against painful adjustments, is it more unthinkable than the bankruptcy of two of the most storied banks on Wall St, or the nationalization of what was not so long ago the world's largest auto company?

2. *Extension of doubts about fiscal health to the US or Japan.* Some countries in Europe that are now under intense market scrutiny, such as Spain, do not have worse debt dynamics than the US or Japan. Yields in those two countries are extremely low because of their reserve currency status and their negative risk premium, but if this were to change, a re-pricing could be very violent.

3. *Major change in the US monetary policy backdrop, re-pricing of the Treasury curve*. While Treasury yields have risen, they remain at historically low levels, and the Fed's policy rate is close to zero, which is unprecedented. This provides the scope for a massive rise in interest rates if the markets begin to anticipate that the Fed intends to

"normalize" monetary policy. Not only are rates far from "normal", but the Fed's balance sheet has ballooned to previously unthinkable dimensions. The Fed would naturally desire to exit its QE strategy when it becomes clear that its objectives – stronger growth and higher inflation expectations – are being achieved. But that is exactly the environment when interest rates are already rising.

4. *China*. Investors are concerned about China's growth and the likelihood that an additional round of goods and asset price inflation will result in the PBoC tightening aggressively. We do not think this is highly probable. Most external observers routinely underestimate China's policymakers' ability to fine tune the economy. And it is unlikely to be different this time.

5. *Double-dip recession in the US*. Economic consensus in the US is unusually consensual in that most economists believe the US will grow 2.6-2.8% in 2011. Unlike during the summer, almost no one expects a double dip recession in the US. We are certainly in that camp. However, Friday's unusually weak report is a reminder that there is still significant uncertainty about the shape of the recovery.

6. *Commodity prices and inflation in EM*. This risk is simply not a tail one. Our calculations made in a recent study (*Easy money is not easy for all EM*, November 23, 2010) indicate that the recent increase in commodity prices should result in only a modest 0.2-0.4% further increase in inflation. However, if stronger commodity prices return, there could be meaningful risks to EM inflation. A key uncertainty is how EM central banks would react to it. We would not expect them to tighten aggressively, but we cannot rule it out, either.

7. *Other risks*. There is a long list of geopolitical risks that could jeopardize the market recovery, including a Korea conflict, a trade war between the US and China, the escalation of the problems with Iran.

EM strategy

Risks in the benign consensus

So the bottom line from our economists is that emerging market investors face a generally benign economic and financial backdrop, with important risks to the positive base case. That is, let's face it, a pretty normal situation, although some of the risks that face the world economy loom very large relative to the minor economic and financial dislocations that confronted investors in the decade or so before the global credit crisis. It is also very much a consensus view at the moment, and therein lies a key risk. Our concern is not so much that the consensus is wrong, but that it is likely to promote positioning that exposes markets to a greater risk of a setback when something happens that falls outside the base case, as something almost certainly will do in the months and years to come.

Too early to turn defensive

We do not think that positioning and valuations have reached the point where market vulnerabilities would call for a defensive approach. Acknowledging economic and financial risks is not the same as being paralyzed by them. After all, 2010 was a pretty good year for global and emerging markets, even though the peripheral European debt crisis degenerated to a degree that few would have predicted a year ago, North Korea carried out two military attacks on the South, and the US economy remained weak enough to spur a major monetary policy initiative from the Fed.

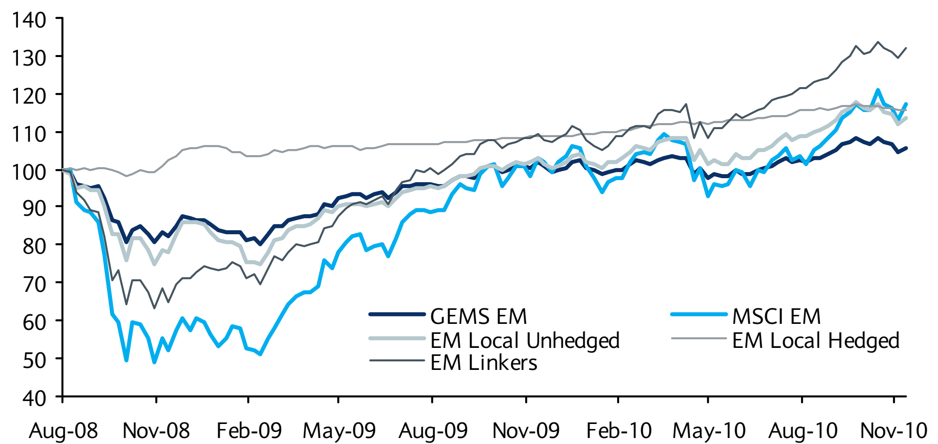
But monitor tail risks, and look for efficient hedges

We therefore join the consensus in projecting a reasonably positive 2011 in emerging asset markets. As the year progresses, we will remain alert to the possibility that markets are delivering too much of a good thing, monitoring the many tail risks to which investors are exposed, and looking for efficient hedges against them.

A return to more normal asset returns in 2011

Even in our benign base case, we think that investors should maintain realistic assumptions about what emerging asset classes will deliver in 2011. We have probably seen the end of equity-like returns from emerging bond markets; we expect emerging EM debt to outperform US Treasuries once again, but to deliver bond-like total returns of 4-5%. While the outlook for emerging currency markets is generally positive, valuations and ongoing official attempts to moderate the pace of currency intervention mean that returns will be contained, and selection is key. We still find long positions in EM FX attractive, but we also see opportunities to hedge global risks. In local bond markets, too, selection will be key, reflecting differences in valuation, positioning, and the immediacy of inflationary risks that we see in many emerging market economies. To obtain the equity-like returns that EM assets have recently delivered, we think investors will need to expose themselves to high yield debt with the outsized risks that accompany the outsized potential returns, or to invest in equities themselves.

Figure 6: EM linkers have outperformed even equities over the recent cycle



Source: Bloomberg, Barclays Capital

Equities: Time to shine?

A good year for equities

Emerging market equities had an excellent year in 2010, delivering roughly 16% returns in the year to December 3, 2010, substantially outperforming industrial economy equities and (by a smaller margin) emerging bond markets. From a top-down perspective, EM equities seem well positioned to capture emerging market economies' medium-term growth outperformance and currency appreciation. The key question is valuation.

Aggregate market valuations look reasonable by historical standards

While national markets vary, it seems difficult to make the case that emerging equity market valuations are out of line with historical experience, or on some other basis displaying irrational exuberance. Figure 7 shows that, with the possible exception of Latin America, equity market PEs are not close to the upper limits of recent historical experience.

Figure 7: Equity-market risk premia are in line with historical experience

	Latin America	EMEA	Asia ex-China
Min	3.3%	4.6%	5.3%
Max	7.7%	9.2%	9.8%
Average	5.4%	6.9%	7.5%
Current	5.3%	7.8%	8.9%

Note: Equity risk premia are computed on a country basis using a variant of the Gordon dividend discount model, then aggregated using 2010 market capitalization weightings. The sample period is 2004 to the present.
Source: Factset, Bloomberg, Barclays Capital

Our estimates of market risk premia are also consistent with historical norms

Moreover, conventional models of equity market valuation suggest that PEs should rise when market interest rates fall, as they have so dramatically done in recent years, when global rates collapsed and emerging market spreads declined. To adjust for this and other effects, we constructed a simple variant of the conventional dividend-discount model to estimate the market risk premium that seems to be reflected in national equity markets. We estimate a market risk premium of just above 5% in Latin America, roughly 8% in EMEA, and almost 9% in Asia. The Latin American estimate is roughly equal to the average over 2004-10, while the premia in EMEA and emerging Asia are well above the recent historical average.

The risk premium is conceptually equal to the expected return on equity investments above a market rate of interest. In the estimation of our model, we used external USD government interest rates. The expected return on equities would therefore be given by the rate of return on US Treasuries, plus the sovereign spread over Treasuries, plus the estimated risk premium. In Latin America, for example, the 5.3% risk premium would translate into an expected total return of about 9-10%, expressed in US dollars.

Sovereign credit: A tale of two markets

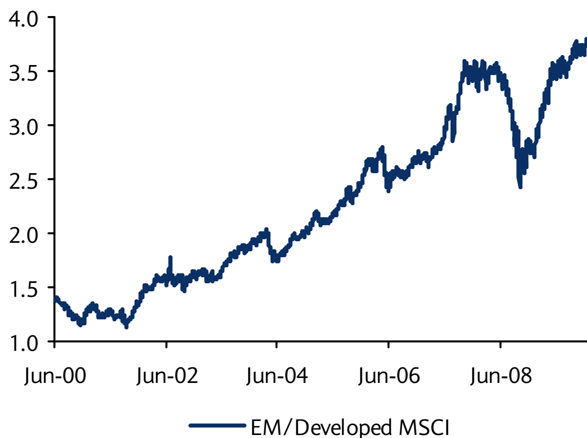
What we thought…

At the beginning of 2010, EM sovereign credit markets had fully normalized and faced, we then thought, headwinds from the higher US Treasury rates that we were then forecasting but support from a gradually improving global economic environment and healthy global credit markets. That added up, we thought, to total returns for our benchmark in the 2% range, outperforming US Treasuries by 400-500bp. We expected about 30bp of spread compression in "core EM" (ie, the benchmark excluding the high yielders Argentina, Ukraine, and Venezuela), resulting in roughly flat total returns, and for the high yielders to outperform the core by about 15 percentage points.

…turned out to be too cautious

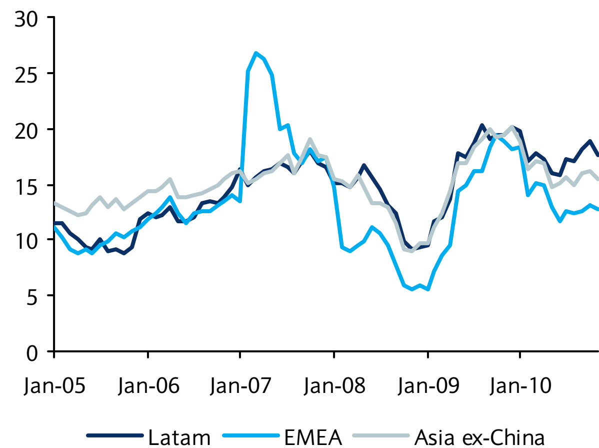
Our forecast of the US Treasury market was excessively pessimistic, and we were therefore way off the mark in our projection of benchmark returns, which have amounted to more like 12% than 2% in 2010 to date. We were overly optimistic about the outlook for Russian credit. But our view that EM credit would outperform Treasuries, that spreads would decline slightly for core EM, and that the high yielders would substantially outperform core credits turned out to be pretty much on the mark.

Figure 8: EM equities have outperformed developed markets



Source: Bloomberg, Barclays Capital

Figure 9: But PEs remain in line with historical norms



Note: PEs are based on 12-month forward forecasted earnings and are weighted by 2010 market capitalization. Source: Factset, Bloomberg, Barclays Capital

A bifurcated market…

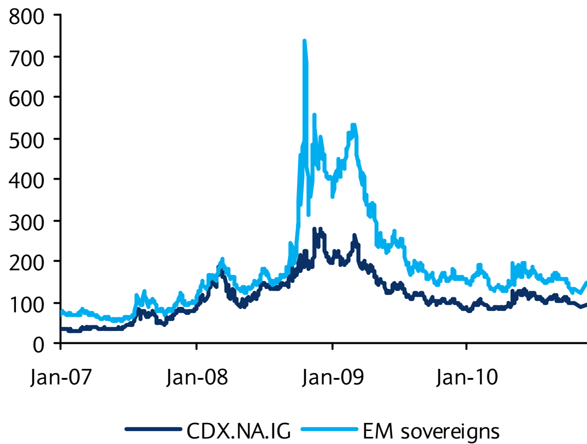
As we approach year-end, we find ourselves in a market context that looks remarkably similar in most respects to the one in which we have been living for the past 12 months. It is clearly bifurcated into a few high yielders, Argentina, Venezuela, and Ukraine, and the other, generally much higher-quality credits. There is limited market differentiation among the higher-quality core credits, which trade almost in lock-step with one another, and with the broader credit markets.

…in which European credits have underperformed

That does not mean that there has been no differentiation at all; during 2010, emerging European sovereigns have significantly underperformed other core credits, reflecting the more serious economic and public financial challenges in countries such as Poland and Hungary and their proximity to the peripheral European economies. (Though not a part of our benchmark, or a very large part of the external debt market, Korea has also underperformed in CDS, reflecting intensified political tensions on the peninsula.)

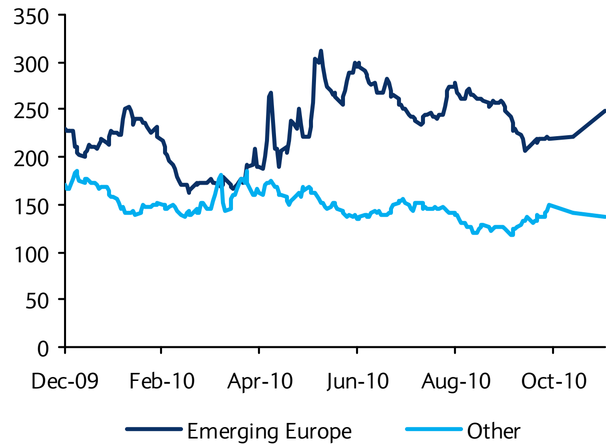
The magnitude of these correlations has become really striking: since the beginning of June, for example, the co-movement among the 5y CDS spreads for nine of the most important non-European EM debt markets accounts for nearly 83% of the total variance in spreads, with idiosyncratic movements a very small driver of relative market returns. During the same period, the correlation between CDX.NA.IG and the average 5y CDS spread of these sovereigns was an astonishingly high 94%.

Figure 10: Reasonable credit valuations



Note: 'EM sovereign' represent is the simple average for Brazil, Colombia, Indonesia, Hungary, Korea, Mexico, Philippines, Poland, Russia, South Africa, and Turkey.
Source: Bloomberg, Barclays Capital

Figure 11: Cost of being in a rough neighborhood (5y CDS)



Note: Europe includes Bulgaria, Croatia, Hungary, Lithuania, Poland, Romania, and Russia. Other countries are Brazil, Colombia, Egypt, Indonesia, Korea, Mexico, Panama, Peru, Philippines, Thailand, Turkey, and Vietnam.
Source: Bloomberg, Barclays Capital

Figure 12: High degree of co-movement and tight linkages with global credit market

	CDS co-movement	Correlation with CDX.NA.IG
11 sovereign credits	57.3%	91.1%
Excluding Hungary & Poland	82.6%	94.3%

Note: CDS co-movement is the fraction of the variance explained by the first principle component of the CDS data, over December 31, 2009-December 3, 2010. The correlation is between the average CDS of the countries in the sample and CDX.NA.IG. The countries included are Brazil, Colombia, Hungary, Indonesia, Korea, Mexico, Philippines, Poland, Russia, South Africa and Turkey, Source: Barclays Capital

Four themes for 2011

This leaves us with the following broad strategic questions for 2011:

1. Is the overall market at some risk of a generalized setback from valuations, flows, or some other market driver?
2. Will the rest of the market remain as highly correlated and tightly coupled to broader credit markets it has been in the recent past?
3. Will the high yielders outperform in 2011, as they did in 2010?
4. Are the European credits that have underperformed in 2010 poised to outperform in 2011?

External debt appears well positioned to deliver bond-like returns in 2011

Here are our thoughts on those questions. First, we remain generally supportive of the market as a whole at current levels and in the benign base case that our economists are projecting. Our global credit team is forecasting another reasonably good year for investment-grade credit, with US investment grade spreads compressing about 15bp. While it would be nice to claim that the higher-quality core of the emerging debt market will de-couple from this broader credit market, we think that the coupling is created by an overlapping investor base that is comparing two asset classes that both have positive credit fundamentals and reasonably supportive technical positions, for the time being at least. While that remains true, we expect emerging debt markets to remain closely linked to their industrial economy counterparts.

Bond supply is not challenging at the global level, but poses some risks for emerging Europe

Emerging sovereign bond supply does not appear particularly challenging; in Asia and Latin America, our forecast of supply is more than covered by interest and amortization payments that will flow back to investors in 2011. The supply outlook is, somewhat less comfortable for EMEA, but our $11.8bn forecast of global net supply should be comfortably accommodated by inflows into the asset class.

Figure 13: Gross and net EM sovereign credit supply forecast 2011 (USD bn)

	Gross supply forecast	Interest payments		Amortizations		Net supply forecast
		USD	EUR (USD equiv.)	USD	EUR (USD equiv.)	
Asia	5.8	3.7	0.0	3.5	0.0	-1.4
Latin America*	17.1	13.9**	1.8	9.4	2.0	-10.0
EMEA	47.7	8.8	2.0	7.2	6.5	23.2
Total	70.6	26.4	3.8	20.1	8.5	11.8

Note: * Does not include PDVSA ** Includes Argentina GDP warrant, but does not include Global BRL, CLP and COP bonds.
Source: Barclays Capital

A modest headwind from global interest rates…

We do expect some headwinds from a roughly 50bp backup in the 10y US Treasury, to 3.5%. But this is not far from what is now priced in the US forward curve and cannot, therefore, be characterized as an interest-rate shock, nor does it signal an imminent tightening of monetary policy, which we expect to remain highly stimulative for some years to come.

…will keep overall returns in the 4% range

In this context, we are forecasting a moderate (c. 15bp) decline in credit spreads for the core credits of our benchmark, generating a total return on this 87% of the index of about 2% and outperforming US Treasuries by 250-350bp. (For details of our projections and positioning recommendations, see the EM Credit Portfolio, below.)

Figure 14: External debt market outlook, 2011

	OAS (bp)		OAD	Weights (%)		Returns (%)	
	3-Dec	12mF		Benchmark	Model	2010 YTD	12mF*
EM Portfolio	267	240	6.9	100	100	12.2	3.8
Arg, Ven, Ukr	826	729	6.5	13	21	20.7	14.1
Other	181	165	7.0	87	79	10.9	2.2
EM Asia	163	159	7.5	14	13	15.0	0.9
EMEA	238	225	5.8	39	36	8.9	2.7
Latin America	324	278	7.7	47	51	14.1	5.7

Note: Forecasted returns are based upon the benchmark portfolio. Source: Barclays Capital

We expect high yielders to outperform again in 2011…

We expect the high yielders Argentina, Venezuela and Ukraine to outperform the rest of the index in 2011, returning about 14% as a group; as a result, we are recommending a substantial overweight position in those credits. We believe that a reasonably robust market context is a pre-condition for these assets to outperform, but that the real drivers, as well as the non-trivial associated risks, are largely local. For more details on these views, please see the regional market outlooks and country chapters below.

…and remain cautious on most European credits

Although, as we have noted, emerging European sovereign debt has generally lagged other regions', we do not think that current valuations offer compelling value in light of the challenging economic and fiscal outlook in much of central and eastern Europe, to say nothing of the exposure that they offer to the tail risk of a severe worsening of the peripheral European crisis. Our largest underweight is in Hungary. We do not consider Turkey or South Africa to be 'European' in this negative sense.

In Latin America, limited grounds for differentiation among the higher-quality credits

In Latin America, beyond our belief that Argentina and Venezuela are poised to outperform, we see relatively limited grounds for sharp differentiation. We prefer Mexico to Brazil and Panama on valuation grounds, but do not expect sharp differences in performance during 2011.

Relative-value and tail-risk trades in CDS

In CDS, our regional strategists have uncovered interesting relative value and tail risk trades that we would like to highlight here.

- In Latin America, we propose a positive carry, default-protected basis trade that permits investors to gain exposure to the Venezuelan credit while securing protection against the ultimate downside of default.
- In emerging Europe, we continue to recommend buying Poland 10y CDS against 5y South African CDS, on a DV01-neutral basis. This trade leverages our belief that the Polish credit is fundamentally more precarious than the South African, provides insurance against contagion risks from peripheral Europe, and capitalizes on the relative flatness of the Polish CDS curve.
- In Asia, we would also look to buy Korea 5y CDS against Malaysia as protection against the risk of an escalation in the Korean peninsula. We recommend putting this trade on if the spread tightens to 20bp (now 25bp).

EM FX: The more things change…

Fundamental drivers of EM FX markets are largely intact…

As we approach the new year, the global drivers of EM FX are largely intact and, in some essentials, uncannily similar to the situation as we saw it this time last year. Yields in the industrial economies are at rock-bottom levels and are expected to remain there for the foreseeable future. Although we expect a deceleration of growth in the emerging world, this is largely because the decelerating economies are approaching full employment and decelerating to a sustainable rate of economic growth. As decelerations go, it does not get much more benign than this. Maturing recoveries and nascent inflation pressures are nudging

policy authorities to tighten financial conditions. Economic outperformance, higher investment returns, and more comfortable fiscal and financial fundamentals should continue to attract capital toward emerging-market economies, putting further pressure on currencies.

…though valuation and official interventions to impede currency appreciation demand a selective approach

Some things have, of course, changed over the course of the past year. First, most emerging market currencies did appreciate in 2010, some to levels that pose valuation concerns for policymakers and market participants alike. The BRL, COP, and, to a lesser extent, the IDR, INR, PHP, TRY and ZAR are among the emerging market currencies that now look expensive in a historical perspective; in some of these economies, modest but growing external imbalances support the view that the currencies are no longer under-valued.

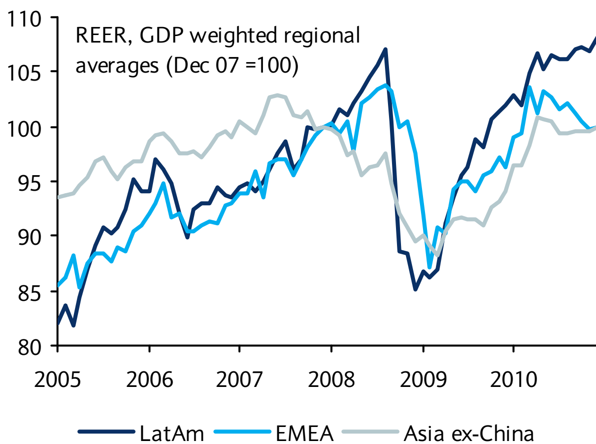
But it is worth noting that the "problem" of historically strong currencies is far from universal. Indeed, our measure of the (GDP-weighted) average real exchange rate in Asia and EMEA remains well below the recent previous peak. In EMEA, currencies actually weakened over the course of the year, and the Asian (ex-China) real exchange rate has been moving sideways since early in the year. (For Asia, real exchange rate appreciation has been tempered by the sharp appreciation of the yen during 2010.)

Second, authorities in all three regions have made clear their aversion to currency appreciation, maintaining more dovish monetary policy stances than may otherwise have been considered appropriate, intervening in currency markets, and imposing tax and regulatory barriers to capital inflows. There is no reason to believe that this official resistance to FX appreciation will abate in 2011, though the ability and inclination to control exchange rate movements varies dramatically across regions and economies.

Higher commodity prices pose upside risks for inflation and EM currencies

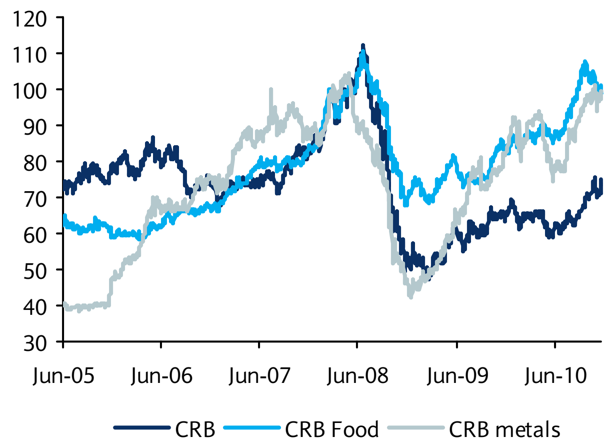
Finally, the 2010 run-up in commodity prices, especially agricultural commodity prices, has created higher headline inflation in many emerging market economies and risks of yet higher inflation down the road. Barclays Capital forecasts of inflation are only slightly higher than the consensus; we are not forecasting a major inflationary event. But in a risk case in which commodity prices continue to rally, the risks to EM inflation are meaningful (*Easy money is not easy for all EM: Rising focus on commodity prices and EM inflation risk*, 23 November 2010). In our view, higher commodity prices and associated inflationary pressures would be supportive of EM FX, as it would force monetary authorities to accelerate the tightening agenda and encourage them to accept more currency appreciation to offset the imported inflation pressures.

Figure 15: EM currency valuations not universally stretched



Source: BIS, Barclays Capital

Figure 16: 2010 commodity run-up poses inflation risk



Source: Bloomberg

In short, continued upward pressure on EM currencies seems likely. This is reflected in our economists' FX forecasts; though we are forecasting some depreciation in eight of the 28 currencies for which we make projections, in only one do we expect the currency (HKD) to underperform forwards on a 12-month basis.

Be picky

That said, not every currency pair looks equally compelling, and we think that selectivity is likely to be (even) more important in 2011 than it was in 2010. Generically, we continue to be attracted to currencies from high-growth economies – mostly to be found in Asia and Latin America – where external flows are robust, valuations are not too problematic, and the authorities' propensity to intervene against currency market pressures is more limited. While we find few spots where outright short positions seem appealing, it is getting easier to find currencies for which shorts are appealing as hedges against economic and financial tail risks.

- In Asia, our most enthusiastic longs remain the PHP and MYR. We continue to find the KRW compelling on grounds of valuation, robust external payments and a strong cyclical context, but we expect authorities to resist rapid currency appreciation, for example, by re-imposing a withholding tax on foreign fixed-income investments, and we take seriously the tail risks associated with the North Korean government's aggression toward the South. The Asian strategy team has proposed a cost-effective strategy to the KRW that pays off in the most likely event of moderate appreciation while protecting against the geopolitical tail risk. We also think that the IDR has seen its best days, and while it is hard to ignore the substantial carry, the Asian strategy team continues to like a bearish put spread on the IDR that leverages the lacklustre outlook for the currency to provide a cost-effective hedge against tail risks around the globe.

- In Latin America, our favoured longs are the MXN and CLP, which we would express against a EUR-USD basket, to minimize undesired exposure to the volatile EUR/USD cross. The CLP offers high growth, reasonable FX valuations, and a central bank that seems less inclined than many to indulge in unorthodox policy measures to suppress currency market pressures. The MXN is appealing mainly on valuation grounds. The BRL is a more complicated proposition; though the economy's fundamentals are sound and interest rates among the highest in the emerging world (and set to rise yet further in 2011), currency valuation metrics are problematic, and the potential for additional heavy-handed intervention remains a concern. We think that the currency will remain under pressure in the year to come and continue to forecast USD/BRL at 1.65 in 12 months. But in the meantime, the currency is at risk of intervention and other potential shocks; we stay on the sidelines for the time being and would be short BRL/MXN.

- While it is particularly hard to generalize about a region as diverse as emerging Europe, it is generally true that the closer the economy to core Europe, the harder it is to like the currency. EUR/PLN, EUR/RON, and EUR/HUF appear cheap and the risks of currency-unfriendly policy initiatives remote. But there are some good reasons for lacklustre currency values, in an economic outlook that is weak by the standards of other emerging regions, public and private financial positions that are more precarious, and exposure to contagion from the peripheral European crisis that is considerably greater. For now, we stay away from central European FX, and we are equally unenthusiastic about the RUB, despite our forecast of higher oil prices in 2010. We do not consider the TRY and ZAR "European" in this temporarily negative sense of the word and advocate exposure to the currency in the form of long, FX-unhedged bond positions.

Rates and local bond markets: Diversity rules

A good year for local bond markets, assisted by stronger currencies

Tighter US Treasury rates and credit spreads, together with stronger currencies, have supported abnormally high year-to-date returns in local bonds across our space. Barclays Capital's EM local currency bond index has gained 10.7% in 2010 year-to-date (as of

December 3), outperforming FX hedged positions by 4.6%. Rate contributions were broadly similar across regions at about 6%, but FX contributions to total returns varied from 8.4% in Latin America to 0.9% in EMEA. Notably, FX contributions were negative only in Poland, the Czech Republic, Hungary and Croatia.

A few interesting patterns emerge from 2011 returns:

- Unlike in external debt, bond duration was not closely related to local bond returns, highlighting the weaker linkages between local curves and global interest rates.
- FX contributions were very weakly correlated with carry.

Opportunities, but also growing risks in local bond markets

We see opportunities in some local markets, but also growing risks from our forecasted rise in global interest rates; still modest but rising inflationary pressures in emerging market economies; and in some cases regulatory or tax interventions designed to reduce pressure on currencies that have the potential to inflict collateral damage on domestic bond markets, such as the Brazilian IOF tax and the withholding tax on Korean bonds. FX gains and carry are likely to be the main drivers of return, rather than local yield compression. Inflationary risks push us toward inflation-linked instruments, where they are available.

This simple logic drives our recommendations in local bonds. We believe investors should strategically position to fend these risks by reducing duration in nominal rates where vulnerabilities to inflation risks are the highest or, when available, by investing in linkers where breakevens are cheap. A constructive view on FX and real rates suggests approaching EM local currency bonds from the long side, with an eye on tactical paying opportunities where markets seem complacent about inflation risks.

Inflation linkers provide an appealing hedge against inflation risks

We recommend linkers in Brazil, Chile, Mexico, South Africa and Turkey. Our inflation forecast for 2011 stands significantly above consensus only in the case of Brazil. Still, the other cases have at least fair breakevens and are vulnerable to global inflation risks. Besides, they offer hedge value to EM local bond portfolios against global inflation risks, particularly because the asset class is fairly small in EM. We like NTN-Bs May 15 in Brazil, 10y UF-Camara in Chile, UDIBonos Dec 2025 in Mexico, SA ILB 2022, and Turkey's IL 2020.

There remains value in nominal space as well; be picky

Despite the inflation risks, we like nominal bonds in Korea, Malaysia, Mexico, and Peru. Prospects for FX appreciation and the recent sell-off makes the 10y KTB attractive relative to equivalent linkers as breakeven widen to 3.22% and the inflation scenario remains benign. As we expect a front-loaded FX appreciation and the carry in 5y5y forward rates is less attractive, 5y bonds are likely to outperform. The recent sell-off in Soberanos 2020 and 10y MGS also offers an attractive entry point into relatively cheap currencies, improving credit, and commodity-supported sovereigns. Exchange rates should offer a good hedge if inflation surprises result from upside surprises to commodity prices.

We believe that the increasingly compelling imperative to tighten monetary policy in some emerging market economies presents a few tactical paying opportunities in short rates. We recommend paying 1y IRS in Malaysia and watching out for opportunities to pay in Taiwan, India, and Korea. We also recommend a 2x5 steepener to hedge against possible bouts of investor nervousness, either due to unease over the long-term inflation path or related to uncertainty over the effect of a scheduled appointment of a new central bank governor (in April) and general elections during summer in Turkey. As is so often the case, Brazil presents a particularly interesting case. We have changed our monetary policy view and now expect 150bp of tightening in the early months of 2011. The market is pricing somewhat more tightening than we expect, but we do not see enough premium to make Brazil a compelling receive, in light of the market's tendency to react strongly to monetary policy inflection points and our view that it is underestimating the likely trajectory of inflation in 2011. We stay out of the market for now and look for more compelling opportunities to arise in 2011.

EM CREDIT PORTFOLIO

	OAS (bp)			OAD	Weights (%)			Returns (%)			Bonds we recommend…	
	31-Dec 2009	3-Dec 2010	12mF		Benchmark	Model		2010 QTD	2010 YTD	12mF*	Buying	Selling
EM Portfolio	284	267	240	6.9	100	100		-0.5	12.2	3.8		
Arg, Ven, Ukr	888	826	729	6.5	13	21	over	4.2	20.7	14.1		
Other	191	181	165	7.0	87	79	under	-1.3	10.9	2.2		
EM Asia	211	163	159	7.5	14	13	under	-1.6	15.0	0.9		
Philippines	178	125	135	8.1	7.5	6.5	under	-1.44	15.7	-0.4	RoP 20s	RoP 14s, 15s, 16s
Indonesia	196	155	150	7.3	5.6	5.2	under	-2.22	14.5	1.1	Indo 14s, 15s, 16s	
Vietnam	324	309	275	5.6	0.5	0.2	under	-1.65	13.4	4.6		
Pakistan	681	699	550	4.7	0.3	0.3	neutral	0.56	15.2	13.7		
Sri Lanka	434	332	250	4.9	0.6	1.0	over	1.36	11.9	6.9	Sri Lanka 15s	
EMEA	249	238	225	5.8	39	36	under	-0.5	8.9	2.7		
Turkey	185	156	135	7.0	13.3	14.0	over	1.43	12.1	2.2	Turkey 15s, 16s, 34s, 36s, 40s	Turkey 19s, 20s, 21s
Russia	187	233	200	6.3	9.0	9.1	neutral	-1.93	8.2	3.9	Russia 30s	
Lebanon	331	310	300	3.7	2.6	2.6	neutral	0.71	9.4	3.1	Leb 4% 17s (amort.), Lebanon 20s, 21s	
South Africa	160	150	125	5.3	2.9	1.5	under	-1.31	7.6	2.3	SoAf 17s	SoAf 20s, 22s
Ukraine	1031	527	450	4.5	1.7	2.2	over	-0.17	28.6	8.5	Ukr 12s, 13s, 15s	
Hungary	224	376	450	4.9	4.1	2.5	under	-3.09	-3.4	-0.2		Hungary 15s, 20s
Lithuania	347	276	250	4.3	2.8	1.7	under	-0.95	7.3	3.5	Lithuania 17s, 20s	
Bulgaria	215	229	230	2.7	0.7	0.7	neutral	-0.15	3.0	2.0		
Egypt	205	187	232	9.2	0.4	0.1	under	-0.56	10.0	-3.4		Egypt 20s
Croatia	228	301	340	5.7	1.3	0.5	under	-1.53	0.2	0.3		Croatia 19s, 20s
Tunisia	231	160	107	1.3	0.2	0.4	over	0.19	5.5	2.0	BTUN 12s, BTUN 27s	
Qatar	146	160	115	6.8	0.0	0.5	over	-1.74	10.6	3.7	Qatar 14s, 15s, 19s, 20s	
Abu Dhabi	166	137	140	4.2	0.0	0.0	neutral	-0.99	9.6	0.7		ADGB 14s
Latin America	336	324	278	7.7	47	51	over	-0.3	14.1	5.7		
Brazil	137	119	100	7.4	13.1	11.0	under	-1.39	11.3	1.6	BR25, BR27, BR34, BR41	BR19, BR A
Mexico	149	142	100	7.7	10.1	10.2	neutral	-2.65	11.2	3.5	MX40	
Venezuela	1032	1116	1000	5.4	5.7	8.6	over	1.56	13.1	17.8	VE22, VE23	VE27
Argentina	708	636	550	8.1	5.9	10.0	over	8.04	25.7	12.3	EUR Warrant, Bonar 13, Bonar 17, EUR Discount, USD disc	
Colombia	177	147	113	7.1	3.6	3.6	neutral	-2.17	13.7	3.0	CO41	CO17
Peru	155	150	110	10.8	2.7	2.8	neutral	-3.28	12.3	4.1	PE50	PE 33
Panama	154	146	140	9.4	2.4	1.4	under	-2.02	13.9	0.7		
Uruguay	215	168	150	9.7	1.8	1.8	neutral	-2.09	17.8	2.3	UY25	
El Salvador	353	296	285	8.3	0.9	0.5	under	1.07	14.8	3.3	ELSALV 35	
Dominican Rep.	438	343	300	5.4	0.4	1.3	over	-0.77	17.9	5.4	DR18, DR27	DR 21

Note: *12mF is the 12-month forecast for the benchmark portfolio. Source: Barclays Capital

FX VIEWS ON A PAGE

Currency	Tactical bias	Strategic directional view	Current strategy/ trades we like	Vol adj 6m returns	Score (1-5)
Emerging Asia					
TWD	Bullish	The economic integration story is intact, setting the stage for more capital inflows next year, mainly into equities and property.		0.52	4.00
MYR	Bullish	Stronger growth, rising commodity prices and fiscal position should boost the currency significantly.	Sell USD/MYR 3M NDF	0.36	3.95
THB	Bullish	A robust economy and a strong external position are likely to support modest THB appreciation.		0.24	3.50
CNY	Bullish	Expect reference to a currency basket and flexibility to continue to be important considerations in the exchange rate.		0.19	3.40
PHP	Bullish	Sharply lower external funding gap, robust remittance inflows and central banks preference for a stronger currency will see USD/PHP move towards 40 by end-2011.	Sell USD/PHP 3M NDF	0.33	3.30
HKD	Neutral/ Bullish	Increasing CNY deposits onshore might result in RMB'isation of the economy.		-0.34	3.15
KRW	Bullish	We believe mounting current account surpluses and preference to contain imported inflationary pressures will see USD/KRW move towards 1025 by end 2011.	Buy 1m USD put / KRW call at ATM-F (1139) with an RKO at 1095	0.25	3.10
SGD	Bullish	The emergence of demand-pull pressures could be a pre-cursor to additional monetary tightening, and likely a steepening of the SGD NEER slope.		0.17	2.65
INR	Neutral	Weak current account and paucity of capital flows to result in INR underperformance.		0.08	2.60
IDR	Bearish	While FDI continues to rise, the current account surplus looks set to shrink providing a less favorable backdrop for IDR.	Buy 3m USD call / IDR put spread with 9100/9400 strikes	0.08	2.20
Latin America					
CLP	Bullish	Growth support, continued monetary tightening cycle and flexible FX regime (at least for now). Still relatively cheap (on a historical basis) on real multilateral terms.	Long CLP vs. EUR (0.35) USD (0.65) basket	0.28	3.40
BRL	Neutral	Good carry, but strong interventionist stance from domestic authorities. Range trade within 1.65 and 1.75 more likely in the months ahead. Expensive in real terms (historical).		0.35	3.25
MXN	Bullish	Mediocre growth outlook, but given flexible FX regime MXN should trade in tandem with US growth outlook gaining momentum ahead. Cheap (historical terms) in real multilateral terms.	Long MXN vs. EUR (0.60) USD (0.40) basket	0.15	2.70
COP	Neutral	In the near term, bad technicals should prevent outperformance. Yet, fundamentals are supportive and valuation is not that over-stretched.		0.14	1.75
PEN	Bullish	Cheap on real (historical) basis and, although FX intervention is high, the PEN has shown the second largest overreaction to the recent re-pricing of global risks factors. Normally low/negative, forward points have recovered sharply due to USD demand related to specific transactions.	Short USD/PEN 2m NDF		
Emerging EMEA					
EGP	Neutral/ Bearish	A moderating macro outlook and concerns surrounding EGP competitiveness all point to gradual depreciation of the pound.		0.38	3.75
CZK*	Bullish	Strong macro fundamentals, healthy bank balance sheets are positive CZK and should limit contagion from peripheral Europe.	Buy 5M CZK call/ sell 2M CZK call (strikes 24.50)	0.34	3.65
HUF*	Neutral	While technical factors seem supportive they are not enough to make us feel bullish against a very risky fundamental backdrop.		0.23	3.30
RUB	Neutral	Concerns over long-term growth and fiscal financing needs will continue to weigh on the currency next year but RUB positive seasonal patterns in Q1 make us neutral for now		0.21	3.15
PLN*	Neutral	While fundamentals look relatively strong, technical factors have deteriorated and fiscal uncertainties have increased. PLN risk premium is not attractive given the local demand for FX refinancing.		0.19	3.00
RON*	Neutral	Continued fiscal challenges, a widening current account deficit and a tepid recovery make RON unappealing.		0.07	2.60

Currency	Tactical bias	Strategic directional view	Current strategy/trades we like	Vol adj 6m returns	Score (1-5)
Emerging EMEA					
TRY	Neutral/ Bullish	With robust fundamentals, a healthy financial sector and sustainable debt dynamics we remain positive TRY, but with less helpful BoP metrics we turn less bullish.	Long TRY vs. EUR (0.5) USD (0.5) basket	0.23	2.50
ILS	Bullish	While we expect continued intervention, a more tolerant approach to shekel appreciation combined with a solid macro story argues for gradual ILS appreciation.	Long ILS vs EUR (0.5) USD (0.5) basket	0.08	2.15
ZAR	Neutral/ Bearish	Healthy appetite for EM assets combined with the absence of Brazil/Korea style intervention measure should support the rand.	Long ZAR Jan'20 (R207) bonds FX unhedged	0.09	2.00
UAH	Bullish	While overall BoP metrics suggest UAH appreciation, policymakers will likely use inflows to rebuild reserves and keep the UAH stable, balancing the interests of exporters and HHs.	Long 5yr VAT bonds, FX unhedged		
KZT	Neutral	The less supportive ruble outlook and continued FX intervention remain large obstacles to KZT strength.			

Note: * Versus EUR. The variable score is an index which ranks EM currencies according to the vol-adjusted returns, PPP valuation, carry, systemic risk, basic balance/GDP and reserves accumulated over the past 5y/GDP. For more details on the trade recommendations, please see the EM Dashboard.
Source: Barclays Capital

MACRO OUTLOOK: ASIA

Bouncing back in 2011

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We forecast GDP growth to slow from 9.2% in 2010 to 7.8% in 2011, re-accelerating slightly to 8.1% in 2012. We expect policymakers to look through this mid-cycle slowdown, continuing to gradually tighten monetary conditions. We note that on a quarterly basis, growth should bounce back in 2011 (even as the annual figure falls) while asset prices continue to rise, credit growth remains solid, and inflationary pressures simmer.

GDP growth is projected to decelerate by 1.4pp in 2011…

Our projections are 0.3pp and 0.1pp above consensus for 2010 and 2011, respectively. Relative to the September *Quarterly*, our 2010 projection is higher by 0.1pp, while we have revised our 2011 and 2012 projections higher by 0.2pp and 0.3pp, respectively. The nominal value of EM Asia's GDP is projected to rise by USD1.81trn, to USD10.93trn, in 2010, increasing a further USD2.06trn, to USD12.99trn, in 2011.

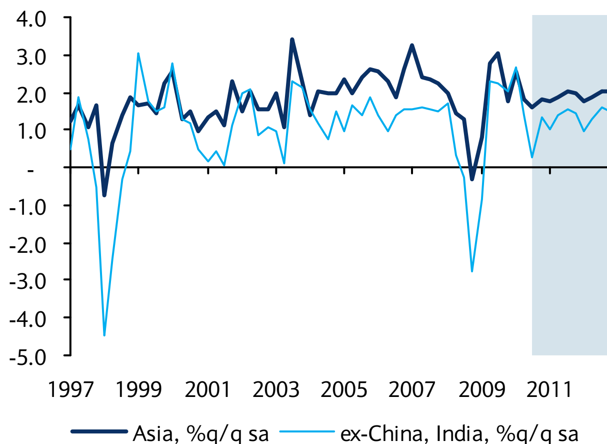
… driven by a mid-cycle slowdown in H2 2010

The V-shaped recovery Asia enjoyed beginning in March 2009 is now over. GDP growth was 2.4% q/q in the five quarters through to June 2010. In September, growth was 1.6% q/q. Excluding China and India, the deceleration in GDP growth is even more pronounced, from 2.1% q/q to a mere 0.25% q/q. The V-shaped recovery has now given way to a soft-patch, or a mid-cycle slowdown in GDP growth, which, while concentrated in H2 2010, will bring down annual GDP growth in 2011 (see Figure 1). In our opinion, this mid-cycle slowdown is attributable to three key factors: 1) the emergence of capacity constraints, 2) weaker global demand for manufactured goods leading to a mini-inventory cycle, and; 3) ongoing withdrawal of fiscal and monetary stimulus.

Capacity constraints begin to bind…

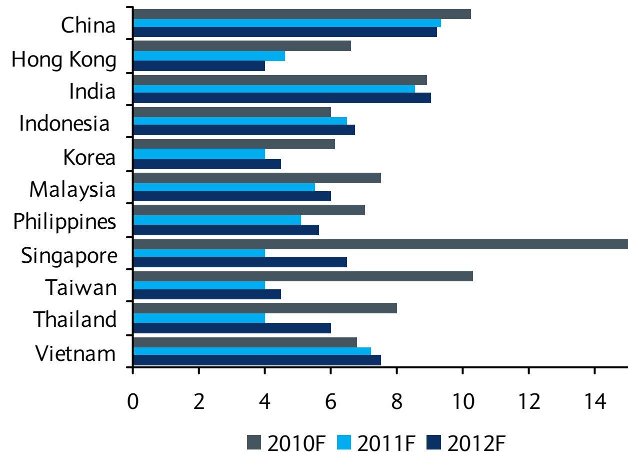
A key factor driving the slowdown in GDP growth is the emergence of capacity constraints. Simply put, Asia has largely re-employed its idle plant and equipment, and surplus labour, and growth is now more reliant on the expansion of productive capacity; additions to the capital stock, increased population of working age, and technological progress. We estimate that the pace of potential GDP growth is in the region of 7.75-8%y/y, more-or-less in line with our 2011 and 2012 projections, implying that the mid-cycle slowdown will result in the accumulation of minimal surplus resources.

Figure 1: The V-shaped recovery has now passed



Source: CEIC, Barclays Capital

Figure 2: GDP growth will be softer in 2011 (%)



Source: Barclays Capital

… as exports slow and industrial production enters a mini-inventory cycle…

While the emergence of capacity constraints provides a structural element to the slowdown in Asian GDP growth, we believe that cyclical factors are also at work. Export growth momentum stalled in Q3 2010, with exports declining 6.2% 3m/3m (saar). The decline in exports was significantly more than would have been implied by measures of external demand and appears to have been concentrated in the electronics sector. We believe that soft demand for electronics may be attributable, at least in part, to a lull in demand ahead of the 5 January 2011 release of the Sandy Bridge microprocessor by Intel Corporation. However, we also believe that, with memories of 2008 still recent, firms' trimmed new orders swiftly in response to the negative news-flow experienced during the summer of 2010. We note that the slowdown in exports is coincident with a rise in inventory/shipment ratios and a moderation in industrial production. We expect this soft-patch in exports and industrial production to prove short-lived and anticipate a recovery in activity in 2011, leading to a bounce-back in quarterly GDP growth (see Figure 3).

… and policy tightening begins to have some effect…

Government consumption and investment spending will contribute 2.1pp to regional GDP growth in 2010, declining to 1.9pp in 2011. While fiscal policy remains a significant driver of activity across the region – and the stance of fiscal policy remains expansionary – the fiscal impulse is now negative (see Figure 4). In China, spending on earthquake rebuilding is likely to slow and policymakers are moving to slow fiscal expansion. In South Korea, the Sejong Administrative City project has been shelved and the Four Rivers restoration project scaled back. In Taiwan, the TWD4trn i-Taiwan project has encountered technical delays while elsewhere in the region, fiscal stimulus is moderating due to a variety of factors including sunset spending clauses, fiscal conservatism and constraints on disbursement of funds.

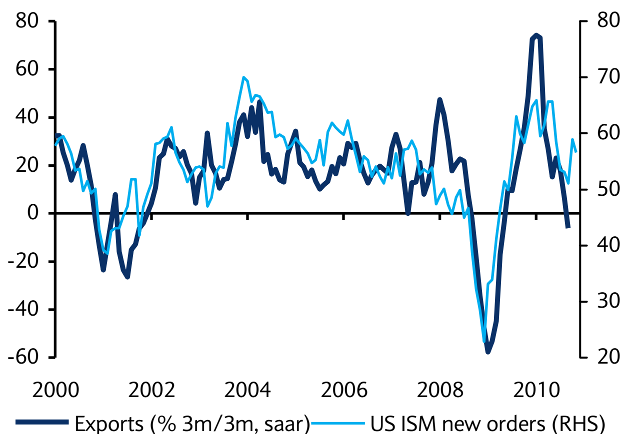
… investment spending is expected to soften…

Weakness in exports and industrial production in H2 2010, coupled with tighter monetary conditions, will slow investment spending from 13.1% in 2010, to 10.1% in 2011, with the contribution to regional GDP growth from fixed capital formation (both public and private) declining by 0.9pp, to 3.7pp, in 2011. While the outlook for investment spending has softened, corporate income and balance sheets remain healthy, the cost of capital remains generally low and credit intermediation remains supportive of investment spending.

… but consumption remains well supported

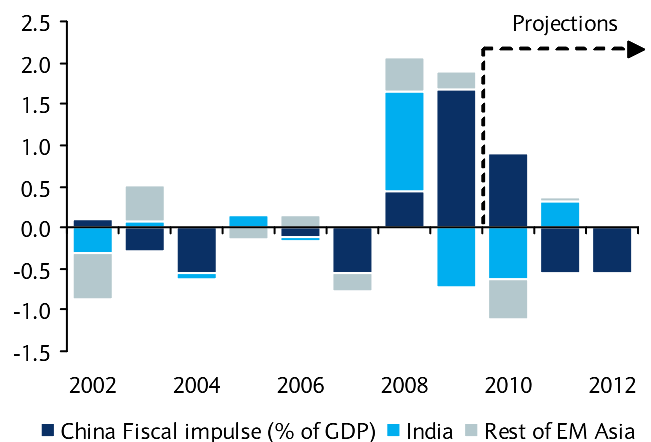
While Asia is experiencing a mild business-led slowdown in activity, consumption spending is likely to remain unaffected, increasing from 7.1% in 2010 to 7.4% in 2011 and 7.8% in 2012. Consumption will remain well supported by household income and balance sheet dynamics. Household incomes are being boosted by rising employment and solid wage

Figure 3: Export growth momentum should recover in 2011



Source: CEIC, Barclays Capital

Figure 4: The fiscal impulse is now contractionary



Source: CEIC, Barclays Capital

gains while balance sheets are benefitting from rising stock and property prices (see Figure 5). As part of its 12th Five-Year Plan, China has announced the strategic goals of re-balancing its economy towards greater domestic demand and narrowing income dispersion. Measures such as increased profit remittance from SOEs, earmarked for social spending, will boost government consumption spending directly, as well as reducing the need for precautionary savings, thereby raising private sector consumption. Wage rises for low-income earners should also boost private consumption.

Region-wide headline CPI inflation has risen to 5% y/y…

Despite moderating economic growth, inflationary pressures continue to simmer. On a region-wide basis, headline CPI inflation rose to 5% y/y in October 2010, and we expect it to remain in the region of 4.5-5.0% through mid-2011, before easing. However, the risks appear skewed to the upside, at least in the near term.

… driven largely by rising food prices…

Headline CPI inflation continues to be driven largely by a temporary shock to food prices. Unsettled weather conditions and rising demand have pushed up the wholesale price of key staples such as fragrant rice (5% ytd), palm oil (35%), wheat (28%) and soya (27%). Looking forward, we expect food prices to stabilise as China releases food from its strategic reserves while India benefits from increased harvests as a result of last summer's normal northwest monsoon, and the current La Nina weather system boosts soil moisture and crop production in South East Asia.

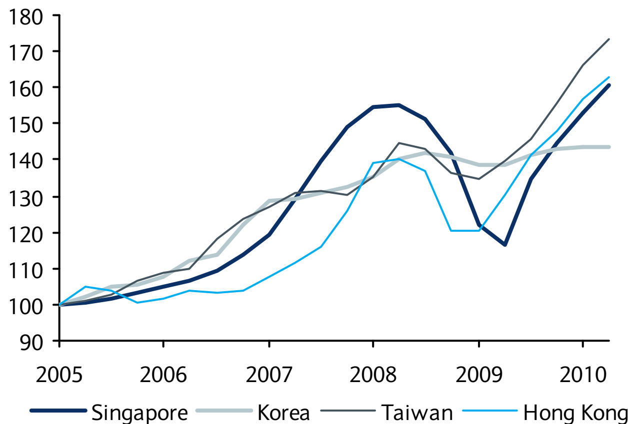
… input-cost inflation is a growing threat…

Core CPI inflation remains benign, increasing 0.5% y/y in China, 0.1% in Korea and 4.0% in Indonesia, in September 2010. Administered price controls and a moderation in economic activity in H2 2010 should suppress core CPI inflation in H1 2011. But as economic activity rebounds, upward pressure on core CPI is likely to build. A key risk factor for regional core CPI inflation is the rising production costs in China. Rapid increases in land, labour and energy costs are boosting producer prices and narrowing margins (see Figure 6).

… energy prices remain a key risk

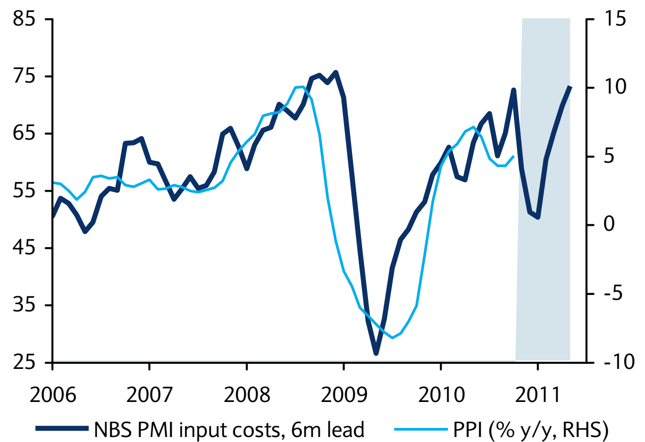
A key risk to our view on inflation comes from petroleum (+11% ytd) and thermal coal (+25%) prices. The pass-through from rising energy prices has been incomplete owing to the effect of administered price ceilings, notably on utilities, and narrower wholesale and retail margins. However, should thermal coal prices continue to rise, the boost to energy subsidies would weigh on government budgets, pressuring the authorities to act. Rising petroleum prices will be rapidly passed-through to the consumer in most countries, but

Figure 5: Households are benefitting from robust wealth effects (property price index, Jan 2005 = 100)



Source: CEIC, Barclays Capital

Figure 6: Rising input costs in China are likely to spill-over into cost structures across the region



Source: CEIC, Barclays Capital

second-round effects within energy-intensive sectors are likely to become more important. Given tight capacity and robust consumption demand, firms are now in a greater position to pass-through price rises rather than absorb them into margins.

Policymakers will tighten monetary conditions gradually

We expect policymakers to tighten monetary conditions gradually; raising the cost of capital, tightening the availability of credit, allowing modest exchange rate appreciation, and using regulatory tools to temper asset price appreciation.

Raising interest rates…

We anticipate further modest interest rate hikes across the region in 2011. However, rate hikes will be constrained by low G3 policy rates, and expectations of Asian currency appreciation. Larger, more closed economies, and/or those with stricter capital controls, are in a stronger position to pursue tighter monetary policy via the interest rate channel, than smaller, more open economies. We expect China, India and Korea to hike policy rates by 75bp in 2011, Indonesia, Malaysia and Thailand by 50bp and the Philippines by 25bp. We expect Singapore could see additional monetary tightening to curb demand-side pressures.

… allowing modest currency appreciation…

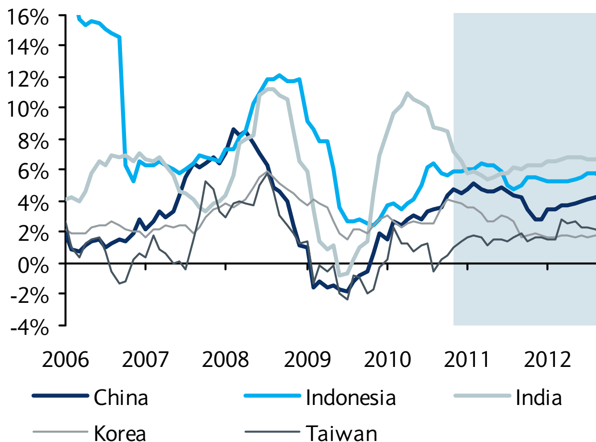
Robust balance of payments surpluses, favourable interest rate differentials and rising import price inflation auger for currency appreciation. However, appreciation is likely to be limited, perhaps 5-10% across-the-board against the USD, and on a real effective basis a more sedate 2-5%. Currency appreciation will be contained by FX intervention, augmented in some countries by tighter capital controls. We expect no change in capital account regulations in Hong Kong, India, Malaysia, Philippines and Singapore. However, we think Taiwan is likely to restrict equity foreign institutional investors' purchases of TGBs, Indonesia to extend the holding period on SBIs from 28 days to 3 months, Korea to re-introduce a withholding tax on bonds while Thailand may introduce a "Tobin" tax.

… tightening credit conditions…

… and using regulatory tools to temper asset price appreciation

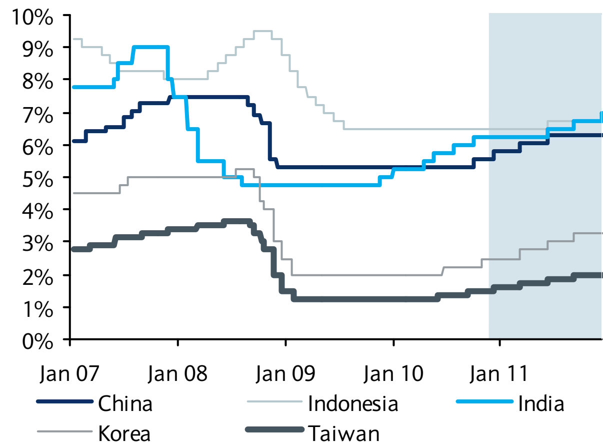
Policymakers are likely to remain concerned about excess liquidity conditions and the concomitant impact on credit growth and asset prices. Policymakers are likely to continue managing liquidity conditions via a combination of tools: reserve requirements, open market operations and buy/sell swap transactions in FX markets. In China, we expect the Peoples Bank to reduce its M2 money target from 17% to, perhaps, 16%, and reduce its new lending target from the CNY7.5trn this year to CNY7trn in 2011. Policymakers have a range of tools at their disposal to manage asset prices, including measures to control leverage (LTV targets, margin requirements, new lending restrictions), measures to increase supply (IPOs, sales from land banks) or direct taxes (stamp duty).

Figure 7: Inflationary pressures continue to simmer



Source: CEIC, Barclays Capital

Figure 8: Policy rate normalisation is continuing



Source: Bloomberg, Barclays Capital

MACRO OUTLOOK: EMEA

German locomotive versus euro area debt fears

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EM Europe's recovery is supported by very robust German growth, while a potential euro area debt crisis creates financial contagion tail risk. The commodity exporters in CIS, MENA and Sub-Saharan Africa are beneficiaries of a robust commodity price outlook. Indeed, as other EM regions slow in 2011, EMEA's growth gap is likely to narrow somewhat. Similarly, it is slowly following other EM regions towards policy rate hikes, particularly as FX appreciation pressures seem to have abated somewhat.

Recovery continues across the region

Some pockets of strong growth (eg, Turkey, Poland, Israel)

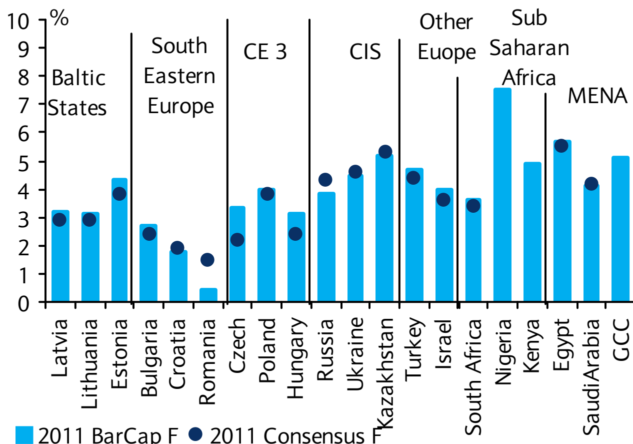
But even in EM Europe's crisis countries, output rebounded better than earlier expected

While EM EMEA's growth remains more sluggish than in other EM regions, the recovery does continue. Indeed, pockets of strong growth have developed wherever countries are not burdened with EM Europe's deleveraging problems (eg, banks' high loan-to-deposit-ratios, households' FX mortgages, etc): output in Turkey, Poland and Israel is rapidly expanding, with significant contributions from domestic credit-supported demand. We raised our 2010 GDP forecasts for these countries, and those for 2011 are above consensus. In light of notably strong growth in core Europe (in particular Germany, but also Sweden), even some of the countries in EM Europe experiencing problems (the Baltic states, Hungary) escaped recession earlier than expected this year. Their growth next year will remain much below pre-crisis years, but is still better than what was often predicted at the outset of some of their "internal devaluation" strategies. Domestic credit growth will likely remain depressed, but the export-led recovery has already created some investment needs (including trickle down FDI from core euro area industries) and improvements in employment, both of which should help broaden the base of growth in 2011. Southeastern Europe has weaker trade links with Germany and, thus, has been benefitting less, making it particularly difficult to implement further fiscal consolidation while growth is weak. `

Kazakhstan leads CIS growth

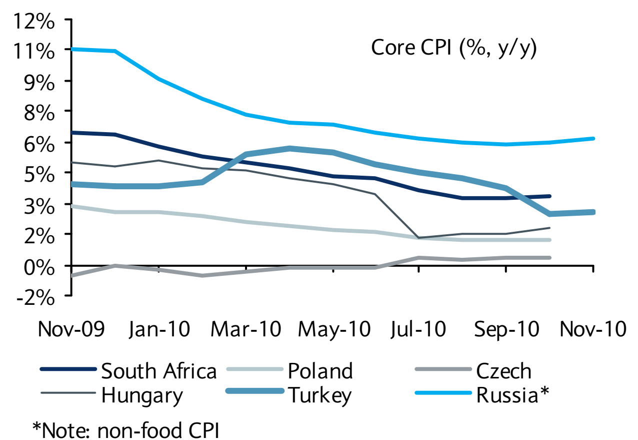
In the commodity-driven CIS economies, Kazakhstan's growth seems best supported, including by large oil-related FDI projects. In Russia and Ukraine, the weather-related harvest shortfalls have led to some downward revisions in growth for this year. Russia's private sector recovery disappointed somewhat, and growth seems still to be relying on government-supported activities. Our house view on rising oil prices ($85/barrel with

Figure 1: Growth recovery in 2011 – Still at varying speeds



Source: Haver Analytics, Barclays Capital

Figure 2: Core inflation – No longer falling but still contained



Source: Haver Analytics, Barclays Capital

upside risk) not withstanding, we see Russia's growth below consensus expectations in 2011 as well. Government-supported activity financed by oil-revenue will also, we expect, remain the backbone of the output recovery in Saudi Arabia and the GCC (in aggregate), where the Dubai-related debt restructurings go into the next phase, remaining a drag on private investment and consumption. In Egypt, government spending is likely to be a significant growth-supporting factor in the election year. For much of Sub-Saharan Africa, the prospects of robust commodity prices provide a supportive backdrop. While we forecast South Africa's growth will remain relatively subdued, many others, led by Ghana, should have stronger growth rates.

Government-related activity still key in Russia, GCC, Saudi Arabia

Sub-Saharan Africa benefits from robust commodity prices

Support from core euro area growth and commodity prices remains crucial for the region…

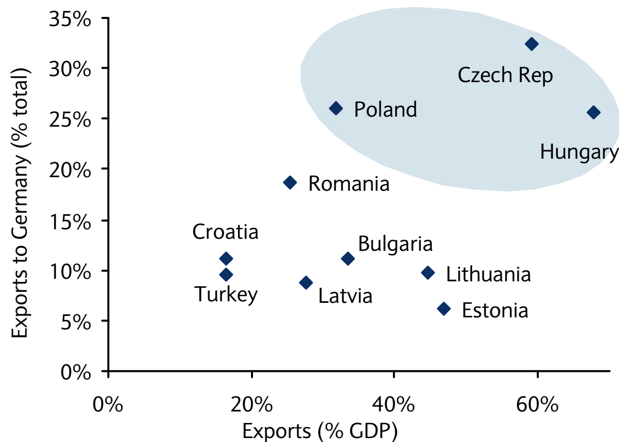
We would try to summarize this very heterogeneous growth pattern for the EMEA region as follows: the growth recovery this year has been, on average, better than expected, providing some positive momentum going into 2011. A few countries (eg, Turkey, Israel), however, seem to have the balance sheets supporting a credit-supported domestic demand recovery. Elsewhere, the recovery remains reliant on oil prices (ie, in CIS, GCC) or the robust export demand (ie, EM Europe) created by the strong growth in the core euro area.

…but potential contagion from a potential euro area financial crisis main tail risk

However, an unexpected drop in German growth or in commodity prices is less of an immediate concern as we enter 2011, in our view. Instead, potential financial contagion from the euro area via financial sector links may pose the greater threat, as some euro area sovereigns and banks have to tap markets for financing in Q1 and uncertainties regarding the resolution of Irish banks and some Spanish cajas remain. Such links were on investors' minds after the Lehman event two years ago, but were alleviated by various forms of IMF/EU/EBRD/ECB support. However, preventing large-scale withdrawal by Western European banks then also means that the exposures are still there now. Some periods in recent weeks have shown how the potential drying up of liquidity quickly affects local asset prices in EM Europe, even in countries that fundamentally are seen as more resilient than the euro area periphery. Such a euro area crisis scenario is clearly not our baseline, but is a tail risk than cannot be ignored and would have adverse real sector implications.

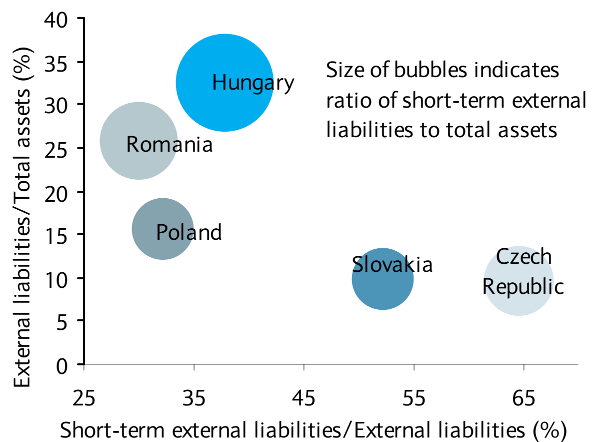
Other external risks, eg, related to current account deficits, remain contained, in our view. With the exception of fast-growing Turkey, there are no sharp returns to the large pre-crisis deficit. Current accounts deficits are either continuing to shrink, remaining in surplus after a large swing in 2009, or only gradually moving towards deficit as growth resumes.

Figure 3: German growth helps those with close links…



Source: Haver Analytics, Barclays Capital

Figure 4: …but financial contagion risk creates tail risk



Source: NBH, Barclays Capital

On the monetary policy side, the chances for additional rate cuts have diminished further. While there may be an outside chance of one more rate reduction in South Africa, the signals are accumulating that countries with robust growth, such as Poland, will finally join early rate hikers, such as Israel, when starting their hiking cycle soon in 2011. In most of the region, core inflation remains subdued and headline CPI increases are driven mainly by food prices. However, inflation-targeting central banks nevertheless seem to have become concerned about inflation expectations settling above their targets and exogenous shocks from food and energy prices potentially creating second-round effects. At the same time, the ongoing turmoil in the euro area has reversed some of the exchange rate appreciations, reducing the concerns that rate hikes would add to excessive FX valuations. Indeed, conversely, concerns about fiscal policy-induced downward pressures on FX likely played a role when Hungary surprised the markets with a hike in November and when other FX-vulnerable countries such as Serbia started to hike rates decisively a few months ago.

…and where the recovery is advanced, rate cycles are likely to start (eg. Poland)

Where FX valuations are a concern, policy makers may use more prudential measures (eg, Turkey)

Policy rates have bottomed…

Turkey stands out as a country where domestic demand expands rapidly, but core inflation thus far has remained exceptionally low and (political) pressures to contain FX appreciation in light of a rapidly widening current account deficit are intense. This is likely to delay any rate hikes to after the general elections in mid-2011. Russia had to halt its easing cycle sooner than anticipated earlier this year, and we now expect the official policy rate to start being raised in Q1, so as not to fall too far behind headline inflation developments. Overall, the region is likely to continue to trail rate developments in other EM regions where the output recovery started earlier and is stronger (ie, Asia, Brazil). However, central banks seem also keen not to let expectations deteriorate, and after trying "macro prudential" policies (eg, increased reserve requirements, limitations on certain mortgages, etc) may also consider initiating very gradual rate hikes, as the risk of jeopardizing nascent recoveries are much reduced.

Commodity prices could put additional pressure on headline CPI

Finally, commodity price shocks pose a significant risk to the inflation outlook not only in EM in general, but to EMEA in particular, according to our recent estimates (see *Easy money is not easy for all EM*, 23 Nov 2010) Although the commodity weights in CPI are not necessarily higher in EMEA, according to our research, the pass through from commodity prices into CPI works relatively fast EMEA. This implies that further rises in food and energy prices in 2011 – our commodity research team takes a more differentiated view here – could relatively quickly translate into rising headline CPI rates.

Passing 2011 budgets has been a struggle in EM Europe

Governments threatened to lose support (Romania)

Others resorted to unorthodox measures (Hungary)

Re-election of Latvia's government encouraging

The fiscal adjustment challenges remain largest in EM Europe, where countries in the final weeks of the year are struggling to pass 2011 budgets that in many cases foresee large additional adjustments (eg, the Baltic states, Romania) under still very modest growth conditions. However, while in some countries this has caused governments to become unstable (Romania) or resort to drastic measures (eg, Hungary's de facto re-nationalization of pension assets), the re-election of Latvia's government in October also gave an encouraging example of fiscal authorities who implemented an extreme austerity package, re-gaining their mandate from the population. Notably, Estonia, which managed to keep a well-below 3% deficit target during an output collapse of close to 15% in 2009, will join the euro area in January 2011, where it will be by far one of the most fiscally sound economies. Despite a number of dissimilarities (eg, largely foreign owned banking systems), the success thus far of "internal devaluation" strategies in EM Europe's fixed currency regimes (Baltics) – regaining competitiveness through radical fiscal adjustments (including wage and pension cuts) – are likely to receive attention in light of the ongoing euro periphery issues.

Figure 5: Hiking cycles are on the agenda, but with varying urgency, reflecting different recovery speeds

Country	Last rate move	Next forecasted move	Risk to our call on monetary policy	FX intervention (aim, direction)	Capital controls
Group 1: Self-sustained recovery					
Turkey	-25 (Nov 09)	+50 (Sep 11)	Delay in hike	Daily FX purchase auctions (build up FX reserves, counter appreciation)	Still unlikely, but government now openly considers them
South Africa	-50 (Nov 10)	+50 (Mar 12)	Additional cut	Discretionary intervention (to buy "excess dollars in the market")	Relaxation of resident FX controls
Israel	+25 (Sep 10)	+25 (Dec 10)	Delay in hike	Discretionary intervention (counter appreciations)	Unlikely
Poland	-25 (Jun 09)	+25 (Jan 11)	Earlier hike	Rare interventions (limit volatility, both directions)	Unlikely
Egypt	+25 (Jun 09)	+25 (Jun 11)	Earlier hike	Discretionary intervention (limit volatility in both directions)	Unlikely
Czech Rep	-25 (Apr 10)	+25 (Apr 11)	Delay in hike	None yet, but CNB has repeatedly warned of interventions	Unlikely
Group 2: Commodity price-dependent recovery					
Russia	-25 (Jun 10)	+25 (Feb 11)	Earlier hike	Rules-based FX intervention (5 kopeck move permitted after $650mn of intervention)	Unlikely. Soft measures possible (reserve requirement changes)
Kazakhstan	-50 (Sep 09)	-50 (Aug 10)	Delay in hike	Discretionary intervention (limit volatility with USD/KZT target band of 135 –173)	Unlikely (FX intervention has proven effective)
Ukraine	-75 (Aug 10)	+50 (Mar 11)	Delay in hike	Discretionary intervention (implicitly aimed at keeping USD/UAH between 7.90 and 8.0)	No new measures (future loosening of controls under IMF program)
Group 3. Export-reliant, not self-sustained, recovery					
Hungary	+25 (Nov 10)	+25 (Jan 11)	Emergency hikes	Discretionary, limited in part through EU fund conversion (counter depreciation)	Unlikely (EU rules)
Romania	-25 (May 10)	Beyond Q4-11	Emergency hikes	Discretionary, very regularly, (counter depreciation)	Unlikely (EU rules)
Serbia	+100 (Nov 10)	+50 (Dec 10)	Hiking cycle could be longer	Discretionary, very regularly, (counter depreciation)	Unlikely

Source: Barclays Capital

Several key elections in 2011

- Turkey

- Poland

- Egypt

- Russia

Particular attention on Nigeria's April election after problematic events in Cote d'Ivoire

A number of elections will play an important role for political and fiscal developments in 2010. In Turkey, the government's solid showing in popularity polls should contain the risk of excessive fiscal loosening in the run-up to general elections in mid-2011. In contrast, in Egypt, the government seems likely to use heavy fiscal spending to quell potential social discontent as the presidential elections approach. In Poland, local news outlets are reporting that the government may seek to bring forward the October elections. This could also bring forward the fiscal reforms, which would be a positive development, as concerns about Poland's apparent fiscal complacency are growing. Russia's elections are still far off, but as the date approaches, the looming question about PM Putin's future will come to the fore again. Earlier than that are the general elections in Nigeria, which are likely to receive additional attention in light of the recent troubled vote in Cote d'Ivoire. Nigerian elections have historically been marred by violence. Zoning agreements haves split the north's support for President Jonathan, a southerner, and tensions along ethnic, religious and regional lines could surface ahead of the April 2011 elections.

Figure 6: EM EMEA elections in 2011 (P - Presidential, G - General/Parliamentary, L - Local government)

January	February	March	April	May	June	July	August	September	October	November	December
	Uganda - P, G	Estonia - G	Nigeria - P, G	Latvia - P		Turkey - G		Egypt - P	Bulgaria -P	Croatia - G	Russia - G
								Zambia - P	Poland - G		Gabon - G
									Oman - P		

Source: Barclays Capital

MACRO OUTLOOK: LATIN AMERICA

Audacious hope

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The region's recovery is coming to an end, though we expect growth to continue at or above potential. The strong external tailwinds suggest the need for greater domestic austerity and discipline. The risk is that policy makers respond too slowly and, furthermore, that they believe the current external configuration to be permanent.

As we move from recovery to trend growth, the greatest risk is policy complacency

Latin America has enjoyed a strong recovery. By and large, economies are booming and domestic demand is typically growing faster than GDP. The recovery has been possible thanks to the strong conditions back in 2008, the extent of counter-cyclical policies, the ability of governments to restore confidence and, also, to very favourable international conditions. Latin America's terms of trade have improved to levels seldom seen in the past. Growth in 2011 is expected to remain above trend and few places show signs that conditions could seriously deteriorate during the year. As we near the end of 2010, amidst a turbulent market backdrop elsewhere, Latin America is a comfortable place to be for a policy maker. However, comfort can rapidly turn into complacency. Indeed, in several key spots in the region, policy makers do not seem to realize how extraordinary and transient the situation could be and appear to be hoping that current tailwinds are permanent.

The risk is policymaker complacency

We expect 2011 to be another year of above-potential growth, though some governments think that the trend may be faster

We expect 2011 to be a good year for the region. We forecast slightly above-trend growth in 2011 for the region (Figure 1). While most of the recovery phase is over, governments are talking about potential GDP growth acceleration. The governments of Brazil, Chile, Argentina, Peru, Colombia and Dominican Republic are either arguing that potential GDP growth is faster than previously thought or have "development" programmes aimed at inducing it. Unemployment is low in Chile, Brazil and Argentina; though the increase that followed the crisis in Mexico and Colombia still needs to be undone (Figure 2).

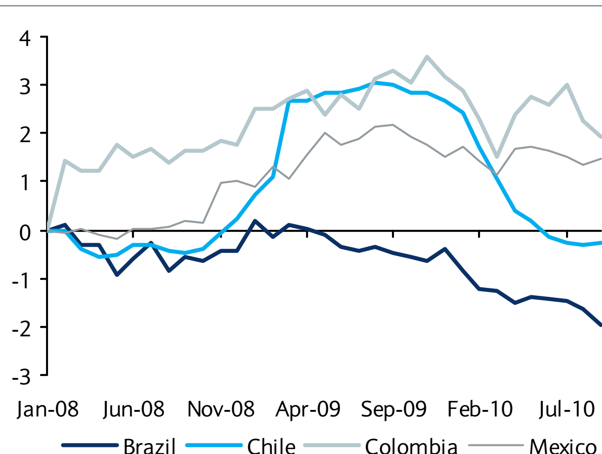
External conditions for the region are very favourable, with high terms of trade and low cost of capital. As a result of the strong growth and advantageous conditions, we believe the most significant risk for the region is policymaker complacency.

Figure 1: An almost complete recovery. On to trend growth

	Barclays Capital			Barclays Capital vs. Consensus		
	2010	2011	2012	2010	2011	2012
US	2.8	2.8	3.6	0.1	0.4	0.6
China	10.2	9.3	9.2	0.1	0.2	N/A
Latin America	6.1	4.3	4.3	0.2	0.1	0.0
Argentina	8.9	5.3	3.7	0.9	0.3	-0.4
Brazil	7.5	4.5	4.4	-0.1	0.0	-0.1
Chile	5.4	6.1	4.5	0.1	0.1	-0.6
Colombia	4.2	4.3	4.1	-0.2	-0.1	-0.7
Mexico	5.1	3.2	3.0	0.2	-0.3	-1.1
Peru	8.9	7.7	6.8	1.0	1.9	1.0
Venezuela	-1.6	2.1	3.6	1.1	1.4	2.2

Source: Consensus Economics, Bloomberg, BCB, Barclays Capital

Figure 2: Unemployment has come down*



Note: *Cumulative changes in the unemployment rate since Jan 08.
Source: Local Statistical Agencies; Barclays Capital

Terms of trade are at near record levels. Global real interest rates are equally extraordinary – this is unlikely to be permanent

Terms of trade are at near-record levels for the region (Figure 3). For instance, Brazil, Colombia, Chile and Argentina have some of the highest terms of trade of the past three decades. In the late 70's, policy makers misjudged a boom in terms of trade as permanent and spent the windfall (and then some), only for the region to later encounter the lost decade of the 1980's. In 2006-08, during the previous terms of trade boom, countries saved much of windfall and used the new margins to smooth out the crisis that followed. However, while the signals are far from the profligacy of the 1970s, several governments in the region appear less prudent than they were only a few years ago. For instance: Chile is undermining the pace of public savings in its stabilization fund; the public sector saving rate has been weakened in Brazil; and in Colombia much hope has been placed on the announced fiscal initiatives but progress has been glacially slow. In Peru and Argentina, the share of spending on nominal GDP continues to grow, despite clear signs of overheating in both economies. Profligacy is not an immediate solvency threat, as we do not foresee a meltdown in terms of trade in the near term; however, the Barclays Capital Commodities research group forecasts a moderate correction in agricultural prices, which could have a sobering effect on the region's terms of trade. Furthermore, at some point in the next few years global interest rates will normalize, inducing an adjustment in external terms of trade.

The boom in domestic absorption is leading to deteriorating current accounts

Domestic demand is booming and domestic absorption is the key source of growth. In Brazil, Chile and Argentina net exports are a significant negative contributor to GDP. The natural consequence is deterioration of the current account (partially muffled by the favourable terms of trade) and an acceleration of inflation. Booming domestic economies and low global interest rates help drive capital flows. As a result, capital inflows will tend to finance the demand for FX, leading to modest currency appreciation. However, when those conditions correct, the domestic adjustment that will follow may prove difficult.

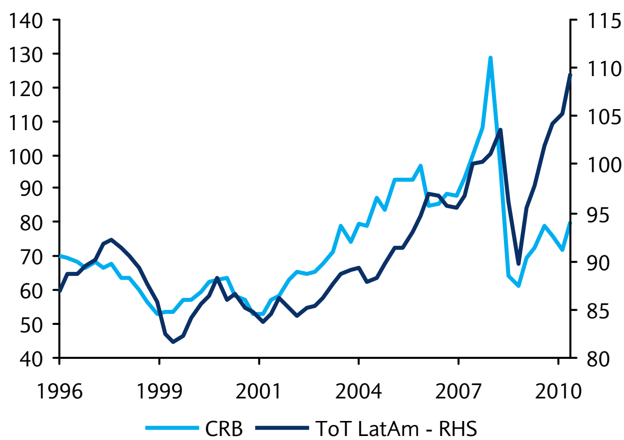
The three pillars at risk

Much of the outstanding macroeconomic performance of Latin America is the result of a three pillared policy framework: floating exchange rates, austere budgets and inflation targeting. Going into 2011, the framework remains in place but all three pillars are being gradually undermined.

Fiscal policy is, gradually, turning pro-cyclical

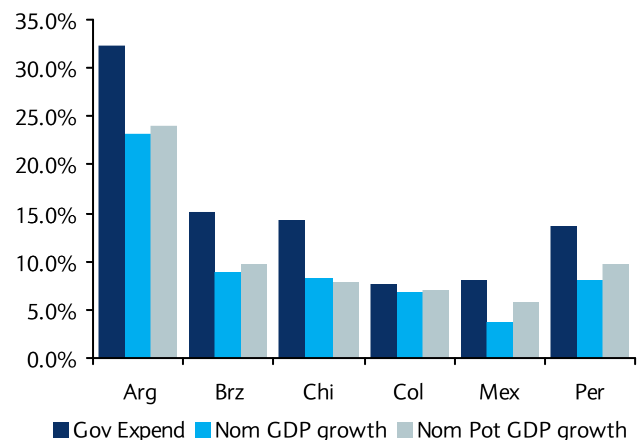
Fiscal policy has grown lax throughout the region. During the fast recovery, Chile, Colombia, Brazil, Peru, and Argentina all grew government spending at a faster rate than potential GDP (Figure 4). Going into 2011, the risk is that the trend continues. The good news is that

Figure 3: Latin America's terms of trade at record levels



Source: Bloomberg, Haver, Barclays Capital

Figure 4: Faster gov spending growth than potential GDP*



*Note: 2009-2010 Average growth rates. Source: Barclays Capital, Local Statistical Agencies

budgets, in general, are a bit more austere. The bad news is that in many cases spending is still expected to grow faster than trend-GDP growth, a clear sign that fiscal policy will remain expansionary. We conclude that fiscal policy has turned pro-cyclical, as the pace of removal of the fiscal stimulus has been excessively slow.

Unwinding the fiscal excesses of the past two years is a key issue for Brazil. Even though the government should moderate the pace of expenditure growth and government credit creation, it is unlikely that it will suffice to induce a rebalancing of the fiscal/monetary mix. The latter should continue to bear the brunt of the adjustment that will happen in 2011.

Inflation may be a growing issue in 2011 and central banks are more hesitant than previously

Monetary policy is very diverse across the region. A common discussion across the region is that neutral (real) rates have declined. Brazil has tightened and we expect it to tighten by a further150bp (starting in Q1 2011). Chile is still in the process of normalizing rates, though we expect the BCCh to pause soon, after a few 25bp hikes to 4%, at the risk of falling behind the curve. Colombia and Mexico still look to be several months away from normalizing. We do not expect Mexico to hike until 2012; however, we also think that a cut in interest rates could potentially come in response to a strongly appreciating MXN (around MXN 11.50).

Is inflation targeting dying in Latam? Not quite, but something is changing. The reaction function of central banks seems to have changed with substantial doubts over the actual level of neutral interest rates, the rate of potential GDP growth and the tolerance for FX movements and growth. Overall, we think central banks will make more extensive use of the inflation bands, with the center of the target losing some meaning, and adopt a more gradual response to changes in the economic environment.

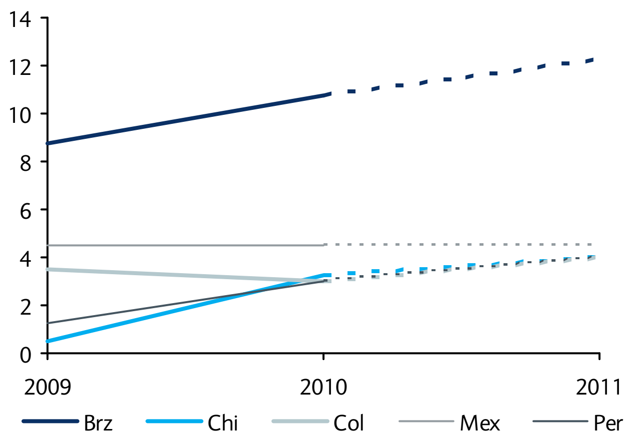
Many central banks will continue to intervene in FX markets

On the FX side, we expect a wide range of responses across the region. However, central banks almost everywhere are sensitive to exchange rates. Except for Chile and Mexico, all LatAm countries tend to follow discretionary intervention policies. While intervention will continue in 2011, we expect Chile and Mexico to only step in if their currencies show additional signs of strength. We expect a continued use of "prudential" regulations and, in Brazil, Peru and perhaps Colombia, an increasing use of administrative measures. The introduction of micro-regulations, however, requires a domestic perception that markets are overreacting as central bankers seem aware of their limited chances of success.

In some countries the pace of growth of credit is a risk

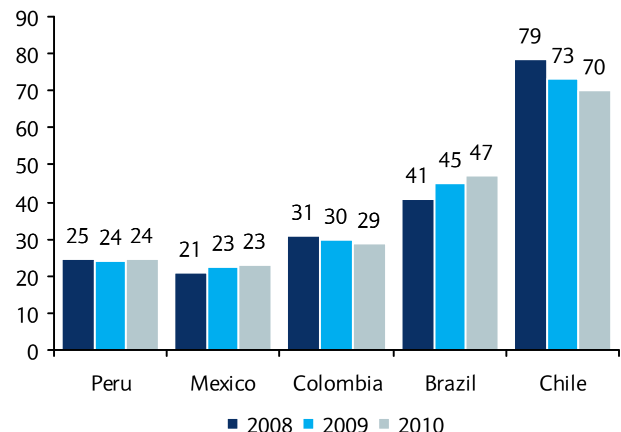
Credit growth is another risk. Asset prices are increasing and, in some locations (real estate in Brazil) the rate of appreciation seems excessive. However, over all, equity valuations do

Figure 5: Interest rate prospects (Target rates %)



Source: Bloomberg, Barclays Capital

Figure 6: Credit expanding in Brazil and Mexico (% GDP)



Source: Local Central Banks, Barclays Capital

not appear stretched, indicating that this concern is not yet real. Nevertheless, the pace of growth of credit is significant. In Brazil, for instance, credit grew 4.2 points of GDP in 2009 and 2.3 points in 2010, the fastest rate of credit growth in Latin America (Figure 6). A significant component of that credit growth is linked, in some cases, to government policies (through BNDES, Banco do Brasil and CEF) to "deepen" credit markets. The problem is that fast credit growth stretches banks' balance sheets and makes countries more vulnerable to episodes of a "sudden-stop" in capital flows. The level of leverage of Latin American economies remains low, though in some countries (Brazil and Colombia) bank credit has grown almost 20 points of GDP in the past five years. More leveraged consumers and firms can lead to macroeconomic difficulties when capital inflows cease.

The Banco Central do Brasil's latest macro-prudential measures represent a first attempt to pre-emptively limit excesses in the credit market. Along with the hike in reserve requirements, the bank also announced higher capital requirements to back long-term household loans. Even though there is a clear monetary policy component behind the announcement, concern about credit and asset bubbles will remain in place, and should be the driver of further prudential measures.

Politics are always an issue

Elections in Argentina and Peru could become a focal point for market anxieties

Presidential elections are scheduled to be held in Peru and Argentina; an important transitional year is expected for Venezuela (2012 presidential elections). While those elections represent potentially important market drivers, it is unlikely that they will result in a macroeconomic crisis in either country. In Peru, the risk is that an anti-system candidate gains momentum, though recent polls suggest this to be a moderate threat. In Argentina, after Nestor Kirchner's death, Cristina Kirchner appears to have gained an important lead in opinion polls. However, the first few indications emanating from the government are that greater political moderation is to be expected in 2011. However, we note that conditions could rapidly change.

Latin America's greatest political risk, at this juncture, appears to be complacency – that governments succumb to the temptation to change the current path and weaken the macroeconomic framework that got us here.

The greatest political risk is that governments mistake current temporary conditions with permanent ones

We think Latin America is in line for another year of strong growth. A testament to the long road tread by the region is that we are now concerned with the ability to manage cyclical policies, rather than risks of default or of large-scale balance-of-payment crises. No wonder that with solid growth and limited risks of crises, investors have flocked to the region. In fact, we think that 2011 will be a strong year for equity markets, private equity funds and M&A activity. However, the risks of policy slippage are very real. The signals emanating from several countries suggest that governments may be mistaking the current extraordinary configuration for a permanent one and responding as if austerity was not needed. Such an attitude could weaken states' ability to act decisively when global interest rates normalize and FX and commodity prices reflect that new reality.

MARKET OUTLOOK: ASIA

Looking beyond risk-on/risk-off

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Asian macro-fundamentals remain robust as we go into 2011. However, market dynamics are moving beyond correlated risk-on/risk-off moves, with idiosyncratic factors driving various asset classes. In money markets, we are now observing opportunities to pay rates. In bond markets, we remain long for now, but we are more cautious. In FX markets, trend appreciation remains more-or-less intact. In credit markets, spreads continue to tighten and we see value only in the more exotic names.

Asia money markets – it pays to be paid

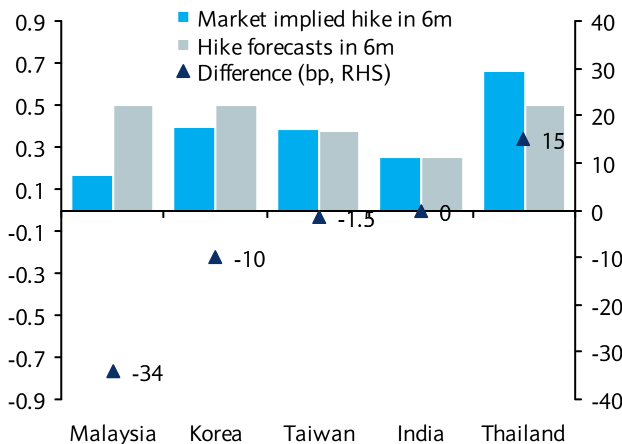
With policymakers likely to look through the mid-cycle slow down, we expect rising asset prices and concerns about inflation to result in generally tighter monetary conditions. While rate hikes should be gradual, we see the hiking cycle starting sooner rather than later. Additionally, risks of capital controls remain – a withholding tax in Korea is a given, Thailand is looking at a 'Tobin' tax, Indonesia is considering higher reserve requirements for banks and, most importantly, China has upped the ante by moving to a "prudent" monetary policy stance from its previous "moderately loose". Against this backdrop of rising interest rates and risk of capital controls, we believe that it will pay to be paid in front-end rates in Asia in 2011 (Figure 1).

We expect strong growth and increasing inflation concerns will prompt Bank Negara to hike rates by 50bp in 1H 2011. As the market is only pricing the first full hike around September 2011, we think there is value in paying 1y MYR rates (Figure 2).

Central banks hiking and risks of capital controls means it should pay to be paid in front end rates

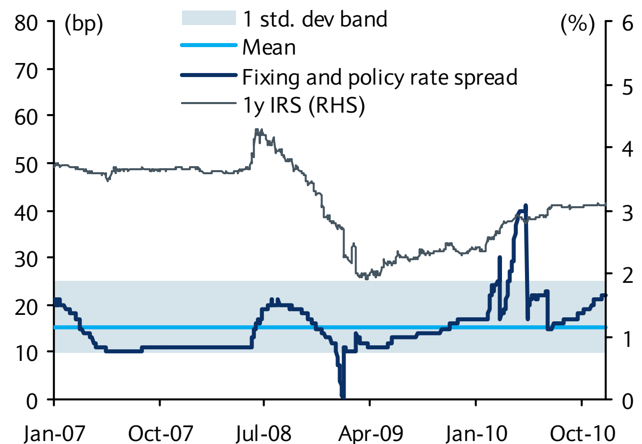
Taiwan, India and Korea rates also merit watching closely. In Taiwan, while the market is pricing in all the four hikes we expect in 2011, we think the CBC might tighten prudential measures, leading to higher short-end rates. Tight liquidity in India remains an issue, and while we are not expecting a hike until 2Q 11, sticky inflation and stronger growth might result in the markets pushing front-end rates higher. While Korea is pricing in an 80-100% probability, depending on the CD rate pass through, of the two hikes we forecast in the next six months, we think there could be value in paying 1y KRW on dips.

Figure 1: It pays to be paid in EM Asia (except in Thailand)



Source: Bloomberg, Barclays Capital

Figure 2: Value in paying 1y MYR rates



Source: Bloomberg, Barclays capital

Thailand remains an exception as we expect it to continue to encourage outflows, thereby keeping the basis trade alive. However, we expect the Bank of Thailand to hike rates by 50bp in 1H 2011, which could pose a risk to receive positions.

Asia rates – buy bonds; but a word of caution

Real money inflows to continue while momentum of flows might be slower

We expect real money investment in Asian fixed income to continue in 2011 as robust growth, relatively contained fiscal deficits (except India) and potential FX appreciation gains attract bond investors. However, higher US yields might result in investors moving down the duration curve, especially as FX returns form the bulk of expected total returns in Asian bonds. Also, cheaper Asian equities will likely result in a slower pace of bond fund inflows, as seen in the past few weeks (Figure 3).

MGS offer the best risk-adjusted total return among liquid EM Asian bonds

We expect Malaysia's 2011 fiscal deficit to come in at 3.9% of GDP compared with the government's estimate of 5.4%, which implies gross borrowing of MYR77.1bn (versus the government's estimate of MYR84.3bn). Coupled with our forecast of 7.5% MYR appreciation, we believe this should support attention on long-end Malaysian government securities (MGS). In fact, we believe MGS offer the best risk-adjusted total return among Asian bonds (Figure 4). However, a possible increase in longer duration MGS issuance and higher US yields, imply that investors focussed on FX appreciation may find shorter tenor bonds more attractive in the near term.

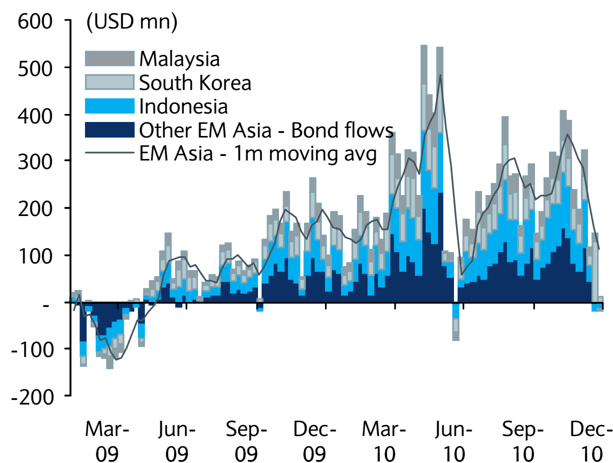
10y KTBs remain attractive; however, tax and tension might result in investors lowering duration risks

With the threat of inflation easing as the BoK uses FX appreciation to contain imported risks, we think foreign investors will continue to find 10y KTBs attractive. However, the re-introduction of a withholding tax could prompt investors to favour lower coupon bonds. Also, we believe offshore investors are likely to lower duration risks if tensions between the North and South remain unresolved.

Stay cautiously long duration in Indo GBs; look to hedge tail risks via OTM USD call spreads.

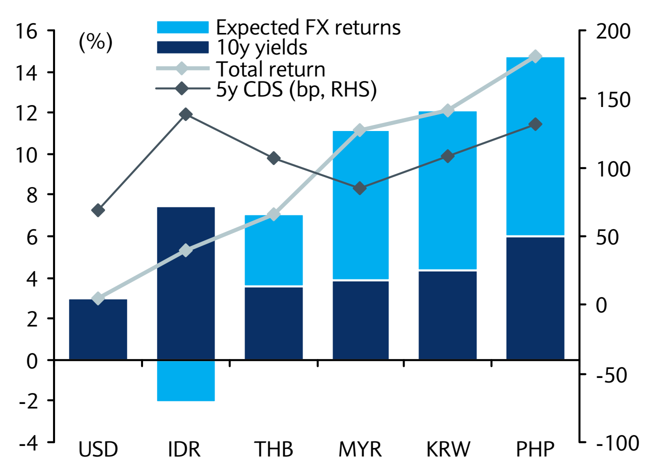
While the recent sell-off in 15y and 20y Indonesian government bonds (IndoGBs) makes them attractive, in our view, it also underscores their vulnerability to foreign outflows (an issue we highlighted in the September *Quarterly*). This vulnerability has risen due to increased offshore positioning and FX underperformance. However, given high nominal yields, it is difficult for indexed fund managers to be underweight Indonesia. We recommend investors stay cautiously long 15y Indonesian bonds but hedge their risks via short-dated NDFs or OTM USD call spreads.

Figure 3: Bond inflows continue even as momentum slows



Source: EPFR Global, Barclays Capital

Figure 4: Risk-adjusted total returns for EM Asia bonds



Source: Bloomberg, Barclays Capital

Asia foreign exchange – appreciation trend intact

We remain overweight currencies with higher beta to the USD index

We expect Asian currencies to appreciate against the USD in 2011. Currency appreciation pressures are significant, driven by: 1) ongoing USD weakness, 2) attractive valuation on a Real Effective Exchange Rate (REER) basis, 3) robust balance of payments; and 4) supportive monetary policy. Our preference remains to be overweight those currencies with the highest beta to the USD such as the KRW, MYR, and PHP. We expect moderate appreciation in the CNY, INR, SGD, TWD and THB while we remain cautious about the outlook for the IDR. We expect no change to the linked exchange rate in Hong Kong.

Currency valuations remain attractive

While currencies have appreciated significantly against the USD over recent years, this largely reflects USD weakness (see Figure 5). Our Real Effective Exchange Rate (REER) indices, which capture third country competitiveness effects – an important consideration in Asia given its high share of manufacturing production in exports – suggests that appreciation has been much more subdued. In fact, since 1 January 2000, only the IDR has appreciated by more than 20% (see Figure 6). In contrast, the KRW (-5.0%), TWD (-22%) and HKD (-28.8%) have all depreciated. In our opinion, valuations remain attractive, especially for the HKD, KRW, and TWD.

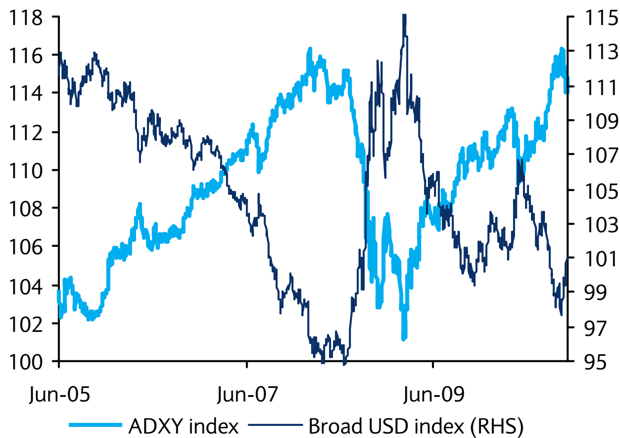
Current account surpluses remain substantial…

We project a region-wide current account surplus of USD433bn (4% of GDP) in 2010. In 2011, we project the current account surplus to widen to USD455bn, but as a percentage of GDP to contract to 3.5%, half its level in 2007. These dynamics are heavily determined by China, where we expect the current account surplus to expand by USD29bn to USD340bn in 2011, but to contract by 0.5ppt of GDP to 4.8% over the same timeframe. In contrast to the rising nominal current account surplus, we project Asia's merchandise trade surplus to decline by USD23bn (0.4% of GDP) to USD179bn (1.4% of GDP) in 2011. The deviation in performance between the merchandise trade surplus and current account surplus is largely attributable to rising investment income on Asia's large net foreign asset position.

…and rising in Malaysia and the Philippines

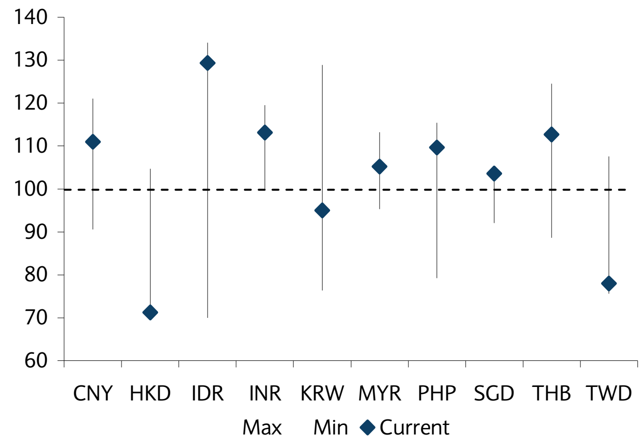
While most countries are expected to experience shrinking current account surpluses, we note two exceptions – Malaysia and the Philippines. We project Malaysia's current account to increase by USD13.3bn to USD38.5bn in 2011, due in large part to rising commodity prices, palm oil in particular. For the Philippines, we are projecting its current account surplus to rise by USD3.8bn to USD14.6bn in 2011, due largely to remittances.

Figure 5: The appreciation of Asian currencies largely on USD weakness…



Source: Bloomberg, Barclays Capital

Figure 6: …on a REER basis, appreciation has been much more subdued (1 Jan 2000 = 100)



Source: Bloomberg, CEIC, Barclays Capital

Capital account surpluses are also expected to be substantial

Net FDI inflows are projected to rise by USD46bn to USD192bn (1.5% of GDP) in 2011. Private sector portfolio flows into equity securities should remain supported by a favourable IPO pipeline, generally moderate valuation, favourable earnings growth expectations and ongoing diversification from developed markets. With Asian bond yields generally above those of G3 markets combined with expectations of future currency appreciation, we expect further inflows into Asian sovereign and corporate bonds.

Central banks remain vigilant, constraining currency appreciation pressures

We expect Asian central banks to continue to balance pressure in the foreign exchange market and the need for stronger currencies to offset imported price pressures, with concerns about the potential erosion of competitiveness. For the smaller, more open economies such as Malaysia, the Philippines, Singapore and Thailand, we expect them to allow their currencies to appreciate to lower the domestic price of imported goods and thus keep inflationary pressures in check. For countries with less sensitivity to imported inflationary pressures and/or greater balance of payments vulnerability, such as China, India and Indonesia, we expect their currencies to under-perform, although India and Indonesia offer favourable interest rate carry. However, we expect all central banks to remain vigilant, leaning into currency appreciation through FX market intervention. Some countries may augment FX market intervention with tighter capital controls; most likely via restrictions on access to onshore fixed income markets and/or taxation on fixed income assets.

We prefer long positions in KRW, MYR and PHP…

….against a short position in IDR (via options)

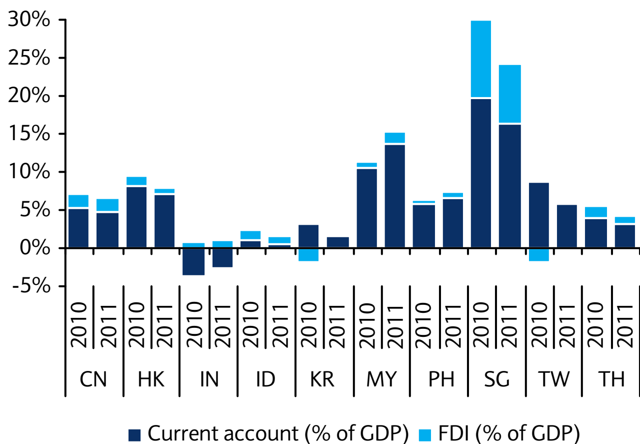
In this environment, we believe that the primary determinants of Asian currency performance are likely to be a country's exchange rate regime, and the degree of flexibility of its central bank. Countries with more flexible exchange rate arrangements and greater willingness to allow currency appreciation are likely to experience FX outperformance. Consequently, we favour long positions in KRW, MYR and PHP. We expect SGD and THB to perform strongly during periods of generalised USD weakness owing to their currency basket management. Over the course of 2011, we expect CNY to appreciate by 5%, but we believe that it too may become more closely managed on a basket basis. We expect INR to perform well during "risk-on" phases and would position tactically long during these periods. Against these positions, we prefer to buy USD/IDR via options.

Asia sovereign credit – still standing strong

Fundamental outlook is benign with an improving bias

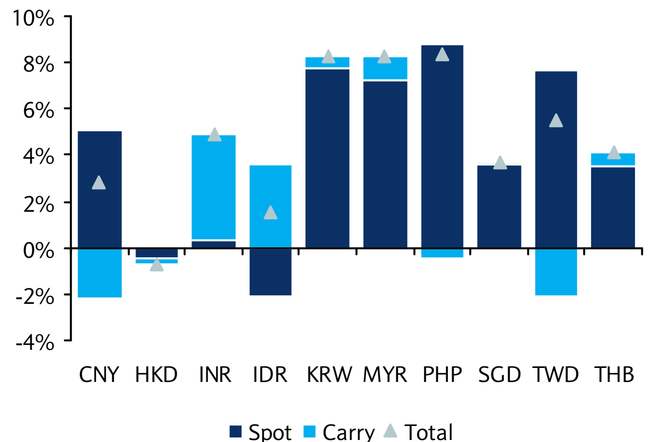
During 2010 we have seen the sovereign ratings of the Philippines, Indonesia, Korea, Sri Lanka, China and Hong Kong upgraded. As we look into 2011, we believe the fundamental

Figure 7: Basic balance of payments dynamics remain supportive of Asian currencies



Source: Bloomberg, CEIC, Barclays Capital

Figure 8: Asian currencies to produce moderate total returns in 2011



Source: Bloomberg, Barclays Capital

outlook for most Asian sovereigns is benign with an improving bias. For the most part, countries we track have kept fiscal deficits in check and have been effective in harnessing global investor interest in emerging markets to their advantage.

Lower bond yields will help deficit targets, given the reduction in debt service costs

Expect Asian sovereigns to issue global local-currency bonds

We see the following themes driving Asia sovereign credit in 2011: (1) Our economists' expectation that the region's growth will moderate in 2011 after the strong rebound in 2010. Notwithstanding this moderation, we still expect growth to be strong enough to support an improvement in debt dynamics. (2) Hard-currency and local currency bond funds have seen large inflows, and the deployments have fuelled sustained rallies across markets. While there is scope for the pace of inflows to slow from current high levels, we do not expect any reversal. (3) The significant reduction in bond market yields (Figure 9) will also help deficit targets given the consequent reduction in debt service costs. (4) In 2011, we expect Asian sovereigns, in particular the Philippines and potentially Indonesia, to issue global local-currency bonds.

HY sovereign supply (external debt) of USD5-6bn in 2011

We estimate that Asia HY sovereign gross supply (external debt) will total USD5-6bn in 2011 (2010 HY sovereign supply including the global PHP bond estimated at USD8.6bn). We also expect sovereigns to diversify their funding sources through the issue of global local-currency bonds. While Asian IG sovereigns do not need to borrow in USD markets, the need to maintain a benchmark for their corporates may lead to issuance.

Expect positive rating action for China, Indonesia, the Philippines and Sri Lanka in 2011

For 2011, we remain broadly constructive on Asia sovereigns and expect positive rating action for China, Indonesia, the Philippines and Sri Lanka.

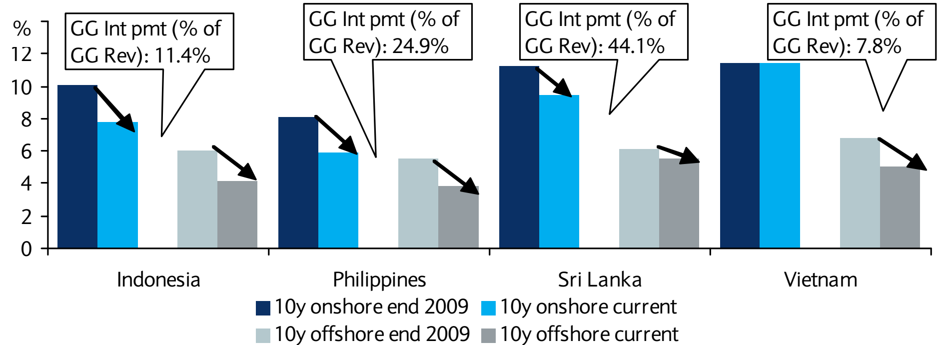
Value in higher-spread sovereigns: Pakistan and Sri Lanka

Philippines offers attractive risk/reward, cautious on Vietnam

Hedge geopolitical risks by buying 5y Korea CDS against selling 5y Malay CDS

We see value in the higher-spread sovereigns such as Pakistan and Sri Lanka. Despite the tight spreads we think the Philippines offers attractive risk/reward, as downside is limited by the strong onshore bid. In 2011, we expect EM investor interest in Indonesia to moderate from current high levels, mainly due to tight valuations. However, we have seen increased interest from Japanese investors and expect this bid to support Indonesian bonds. Lastly, we recommend a cautious stance on Vietnam given that inflation is trending higher (2010F: 8.0%) and the unofficial market USD/VND rate is indicated at 10.3% higher than official rate. With the recent hostilities in the Korean peninsula, and risk of escalation, a short position in Korea CDS could provide a suitable tail risk hedge. We recommend buying 5y CDS on Korea sovereign and selling 5y CDS on Malaysia sovereign (to mitigate the cost of the position). Given recent widening, we would put the trade on in full size only if the spread narrowed to less than 20bp.

Figure 9: Change in funding costs for Asian sovereigns



Note: 10y offshore yields based on INDON 5.875% '20s, PHILIP 6.5% '20s, SRILAN 6.25% '20s and VIETNM 6.75%'20s. For Indonesia, Sri Lanka and Vietnam, 10y offshore yields taken on issue date. The general government interest payments as a % of general government revenue is for 2009.
Source: Moody's, Bloomberg, CEIC, Barclays Capital

MARKET OUTLOOK: EMERGING EMEA

Up the icy path

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The levels of risk premia across EMEA FX, Rates and Credit markets are modest. That is not to say that the markets are overvalued, particularly as the macroeconomic backdrop does not signal major problems. However, the room to manoeuvre is limited and this suggests 2011 will present more difficult conditions for EMEA markets. The upside from bullish trades is limited in light of the EMEA-specific risks, namely the threat of contagion risks from the periphery of the euro area to CE alongside elevated (external) borrowing needs.

- A key EMEA theme to highlight is the generally low inflation and in some cases, only modest growth upswing. This means, we think, less pressure for hiking monetary policy and a greater degree of freedom for policymakers to act against currency appreciation.
- The supply of sovereign paper is also an issue. On local bonds, gross issuance is generally contained with the notable exception of Russia. However, on the external front, increased supply from the CE region may create pressure points for asset prices. These relative supply dynamics contrast with other EM regions.
- In Rates: The supportive global bull flattening is behind us, increasing the risk on receivers. We recommend paying HUF and PLN 5y IRS to leverage off the macro uncertainty in Hungary and in Poland, the worsening debt dynamics. We do still have long bond recommendations notably in South Africa and Turkey.
- In FX: We look to be long ZAR and TRY through the FX legs of bond trades. Separately, we like UAH for the carry and ILS for spot appreciation.
- In Credit: We express our more cautious view on the CE region via two CDS pair trades and recommend buying Poland 10y CDS vs SOAF 5y CDS and buying Croatia 5y CDS vs Romania. Similar to Romania, Ukraine enjoys a strong policy anchor by the IMF and given attractive valuations, short tenor bonds are a solid carry trade, in our view.

Figure 1: EMEA highest conviction trade recommendations

	Current	Target	Expected Excess returns to Mar 11	Expected Sharpe
Defensive trades in CEE				
Credit: Buy Poland 10y CDS, sell SOAF 5y CDS (DV01-neutral)	41	70	1.5%	1.5
Rates: Pay HUF 5y IRS	6.95	7.90	3.7%	1.2
Rates: Pay PLN 5y IRS	5.4	5.8	1.7%	1.0
Carry trades				
Rates:/FX: Long UAH (through VAT bond)	8.0	7.95	3.8%	2.4
Rates: Long RON 6m Tbill/FX hedged	6.5	6.5	1.6%	2.0
Credit: Long Ukraine '13/OW Ukraine cash credit	525	470	3.0%	1.1
Rates/FX: Long ZAR Jan'20 (R207) bond FX unhedged	8.15	7.80	4.4%	1.0
Rates/FX: Long TRY Mar'12 bond FX unhedged	7.34	6.75	3.5%	1.0
RV trades				
Credit: Buy Croatia 5y CDS, sell Romania 5y CDS	58	0	2.7%	2.0
Rates: TRY 2s5s (CCS) steepener	80	125	0.9%	1.4

Source: Barclays Capital

We do not foresee major macro upsets on growth or inflation in the EMEA region. However, risk premia in EMEA local bond and credit markets are low and there are sizeable pockets of foreign positioning in local bonds. These factors thin-out the ranks of decent bullish trades. In local space, we favour South Africa and Turkey but with limited upside. Ukraine still looks good in both FX and credit space. Investors should look more to RV and defensive trades in EMEA, in our view. 2011 sees general elections in Turkey, Russia and Poland (among others). These are discussed in our EMEA macro section but at the very least, they represent an additional source of distraction for the market.

Limited risk premia in EMEA and challenges ahead

Low risk premia and positioning are not, *per se*, a problem given our constructive baseline scenario of structural re-allocation flows to EM. However, EMEA markets seem more risky than others given the external debt rollovers and contagion channels from the periphery of the euro area (to CE in particular). The banking linkages mean that euro area problems can lead to squeezes in external financing for CE banks and we have seen a few example of this in 2010 with swift knock-on effects for CE FX. Needless to say, peripheral euro area problems could also dampen growth. Moreover, the external supply outlook for the CE region looks unfavourable relative to other regions in global EM (Figure 3). As CE is the only region with a meaningful increase in external debt supply, according to our estimates, the region's credit spreads seems vulnerable to supply pressures.

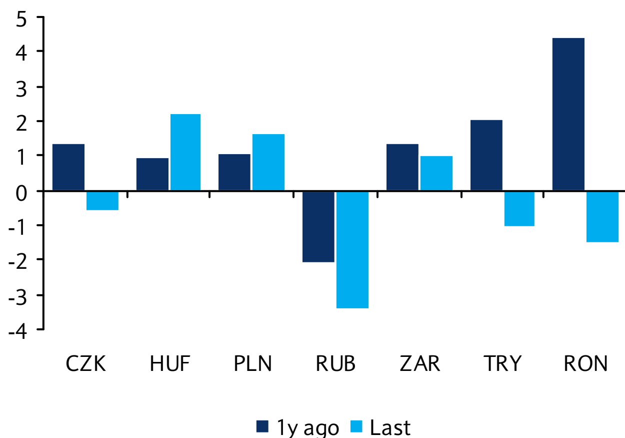
Russia – question marks over the staying power of growth

A key theme for EMEA is, in our view, the challenging macro outlook for Russia. The paucity of structural reforms here is mirrored in the relatively modest cyclical bounce, the capital outflows and inability of the country to attract meaningful FDI. The experience of the last two years suggests that either valuations need to be very appealing or technicals supportive to see significant inflows. In the absence of 2007-style oil price gains, a sharp turnaround seems unlikely to us.

Bystander in the 'currency wars'

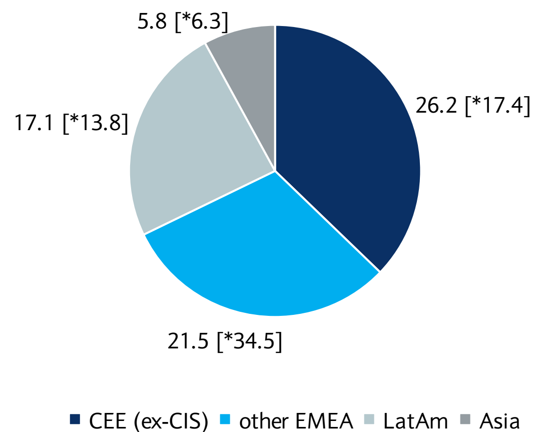
EMEA should broadly remain a bystander in the 'currency wars'. Unlike the other EM blocks, EMEA runs current account deficits and has large external debt rollover needs. The inflation risks are less widespread as well, giving EMEA central banks a greater degree of freedom on monetary policy and FX intervention. Even if EMEA sees a repeat of the inflows of 2010, we will likely see more FX intervention and, only in rare cases, withholding taxes to slow these inflows. We do not see much risk of capital controls but then, opportunities for FX appreciation also seem limited.

Figure 2: Low-to-negative real rates is one indicator of low risk premia for EMEA (local) markets*



Note: * 1y rates less realized CPI growth, %. Source: Barclays Capital

Figure 3: Global EM sovereign hard-currency issuance in 2011 looks skewed towards the CE region (numbers in USD bn)



Note: *Numbers in brackets are 2010 (Jan-Nov) issuance numbers for comparison. Source: Barclays Capital

EMEA rates: Addicted to flow

Lower premia but higher tail risks

We still see some room for receivers in EMEA; however, we are gradually moving to a more cautious stance. Heavier investor positioning has meant that technical factors have become less supportive. Inflation trends have turned around, reducing real yields further. In addition, EMEA curves, generally speaking, are very flat beyond the 2-3y maturity sector, offering little premium for expansionary fiscal policy. Although 2011 net local bond issuance will be reduced, gross numbers are not dropping (Gross y/y: Poland -10.9%, SA +3.7%, Turkey +1.9%, Hungary +2.6% and Russia +37%), and in absolute terms can hardly be described as small. That will keep particularly Poland and Hungary dependent on foreign savings flow and leave both vulnerable to euro area periphery jitters. Notwithstanding that, the outlook is not uniformly bearish as we do have differentiation across EMEA. We see value among fundamentally strong economies and those where financing needs are secured by EU/IMF programmes. These offer better entry levels after the recent selloff.

We favour long SA bonds and we still like Mar 12 bonds in Turkey

Hence, our highest conviction long is SA bonds. Technical factors and fundamentals are supportive. With regard to curve shape, the 2v10 is now pricing at +182, near the peak reached at the end of the last two cutting cycles and is therefore also attractive to receive. In Turkey, we expect the CBT to keep its interest rates flat for longer given the recent fall in the CPI rate. We still recommend being long Mar'12 bonds, which are 45bp cheap to swaps.

We see RV opportunities in buying RON 6m T-bills, funding out of 1m FX implied RON

In RV space, we recommend buying RON 6m T-bills funding out of 1m FX implied RON. Romania looks fundamentally weak but the curve is very steep and the IMF programme provides a ceiling for T-bills yields. In Turkey, we recommend a 2s5s DV01 neutral steepener trade in CCS, which reflects our view on s/t rates and hedges against investor nervousness.

We adopt a defensive strategy on Poland and Hungary

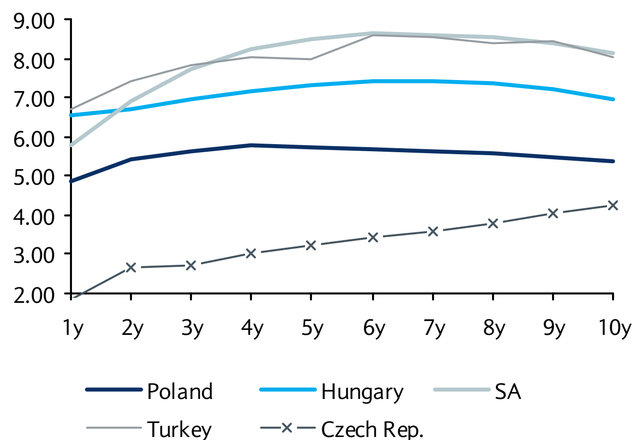
We recommend paying 5y Hungary IRS given the refinancing pressures and the premia that the market will likely ask amidst macro policy uncertainty. Monetary policy is being tightened and 5y spreads to EUR are 100bp less than mid '09, a comparable juncture of macro uncertainty but a helpful global backdrop. In Poland last year, strong inflows trumped weak fiscal policy. Foreign holdings of POLGBs have jumped 50% y/y but most recently nominal yields bounced back to the level seen 12 months ago. Given the already substantial exposure of foreign investors to POLGB's, the less benign inflation outlook and fiscal uncertainty, we expect flows to weaken. We recommend starting cautiously paying 5y rates.

Figure 4: BarCap forecasts on policy rates and government bond yields

current	PL	HU	TR	SA	RU
Policy rate	3.50	5.50	7.00	5.50	7.75
2y	4.7	7.4	7.4	7.1	6.2
5y	5.4	8.0	8.2	7.9	7.4
3M forecast	**PL**	**HU**	**TR**	**SA**	**RU**
Policy rate	3.75	6.00	7.00	5.50	8.25
2y	5.0	8.0	7.4	6.9	6.7
5y	5.7	9.0	8.7	7.4	7.9
12M forecast	**PL**	**HU**	**TR**	**SA**	**RU**
Policy rate	4.25	6.00	7.50	5.50	8.25
2y	5.5	7.5	7.7	7.2	7
5y	6	8.5	8.9	7.6	8.2

Source: Barclays Capital

Figure 5: Value in South Africa and Turkey, but little in the way of premia in Polish or Hungarian bonds



Source: Barclays Capital

EMEA FX: Pockets of cheapness but for a reason

Low premia will generally be a challenge

We have turned a little more cautious on EMEA currencies. Some of our markets can still pull in decent portfolio inflows as they offer a sweet spot of sustainable strong growth and low inflation, appealing to both offshore equity and bond investors (Turkey and South Africa). Elsewhere, the prospects of sustained strong capital inflows seem remote.

Our favoured longs, in mainstream EMEA are TRY and ZAR as the currency legs to the underlying bond trades. Without the bond positions (which increase the carry on the trade), TRY makes a little less sense as a long. Here, FX intervention is sizeable and there is some downside volatility in money market rates, which themselves are meaningfully below short tenor bond yields. There are fewer such problems on the ZAR and policymakers there seem rather reluctant to throw sand in the wheels of capital inflows, which likely means ZAR benefits from inflows diverted from markets where the risk of capital controls is increasing. In terms of carry trades, UAH is still an attractive long, in our view. This is clearly not mainstream EM but Ukraine's BoP is likely to remain solid in 2011 and the carry is in low double digits. All three of these bullish trades are likely to generate most of their returns from carry, while the only currency which we see delivering spot appreciation is ILS, where a rapidly growing economy and inflation risks likely persuade the BoI to allow currency appreciation.

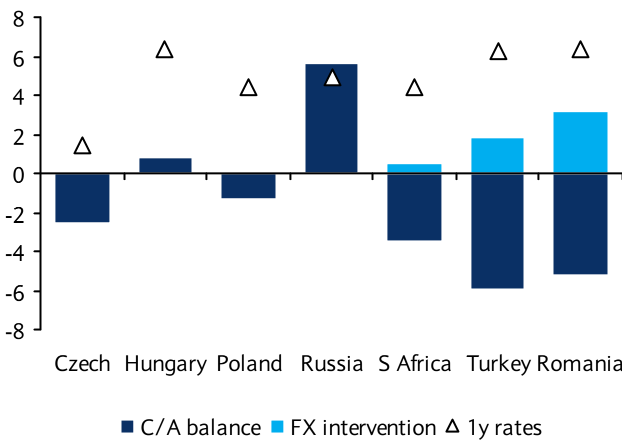
Trading the rouble tactically

The rouble has been under pressure since May, partly because of the narrowing C/A surplus and partly through growth concerns that have led to net capital inflows (M&A money flowing out and a paucity of portfolio and FDI money coming). We don't anticipate a shift in this overall balance but recognise that seasonally speaking, Q1 is a more helpful period in the BoP with a larger (than usual) C/A surplus and lighter external debt repayments.

Risks for Central Europe mount – contagion channels from peripheral euro area and squeezes in FX term funding

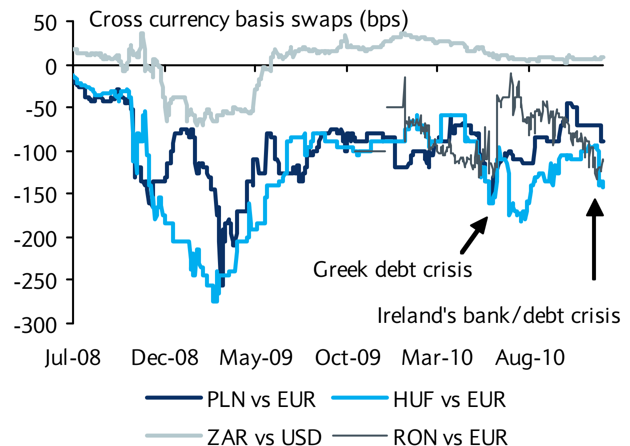
CE FX is hard to categorise. Valuations are attractive for long-term FDI flows but these flows were in short supply in 2010 and seem unlikely in 2011 as well. Meanwhile, CE FX remains hostage to contagion risks from the periphery of the euro area and squeezes in term FX lending. The latter channel needs to remain open to facilitate the rollover of debt. But with investor concerns over euro area banks, further disruptions in these flows seem likely. Tactical opportunities will arise but a neutral HUF, RON and PLN stance seems most sensible on a multi-month basis.

Figure 6: Given the BoP metrics, the pressure for appreciation in EMEA is not as great as elsewhere. Low inflation gives policymakers more freedom to intervene.



Source: Barclays Capital

Figure 7: Meanwhile, contagion risks for CE FX exist from sporadic squeezes in foreign funding



Source: Barclays Capital

EMEA credit: Pressure points

Elevated issuance needs, close ties to Western Europe and, in some cases, fiscal concerns put CEE credits in a weak spot

We expect many credits in the CEE region to remain in a weak spot, with continued vulnerability to further bouts of widening in Western European spreads. In light of the events in Western Europe over the past quarter, those countries close to the peripheral euro area "fiscal danger zone" have clearly felt the knock-on effects, particularly Hungary and Poland. Across the CEE region, the elevated issuance needs reflect still precarious fiscal positions in some countries and, on a relative value basis, could lead to pressures versus other parts of the EMEA region and versus LatAm and Asia, in our view.

We recommend buying 5y CDS on Croatia versus Romania

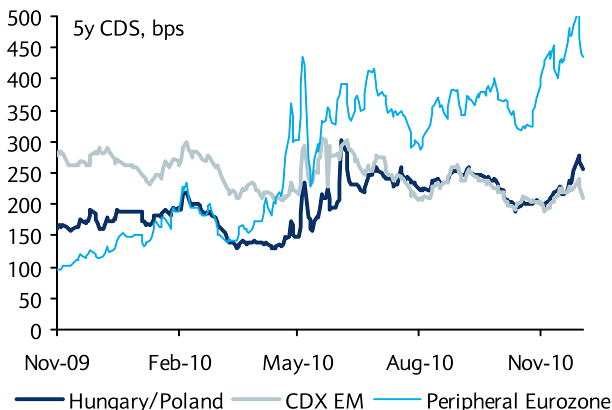
Ukraine's attractive carry argues for long/OW positions, particularly at the short end

Hence, we maintain underweight positions for most countries in the region in our Global EM credit portfolio – Hungary and Croatia in particular. For the latter, the outlook appears increasingly challenging as subdued growth and low competitiveness have put pressure on the fiscal position. We recommend buying 5y CDS versus selling 5y CDS on Romania. Similar to Ukraine, the policy anchor in Romania provided by the IMF programmes should keep risks contained and, given the attractive valuations, argues for long positions. In Ukraine, investor positioning is not as helpful as it was in past quarters as after the political developments and the IMF agreement earlier in the year, investor scepticism and default concerns have clearly receded. While this may prevent an aggressive spread rally from current levels, the attractive carry, particularly at the shorter end of the curve, still argue for overweight positions, in our view.

We maintain a small OW on Turkey, but take a market weight stance on Russia

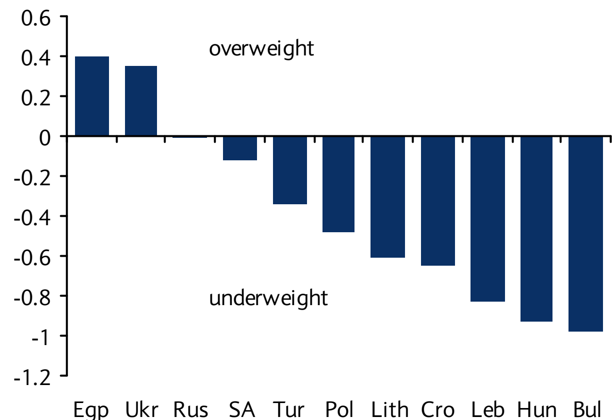
We also maintain a slight overweight on Turkey. Although valuations look tight on a historical basis after the significant outperformance over the past quarter, we think that the strong fundamentals should leave room for some further spread compression in our constructive baseline scenario, while at the same time keeping it sheltered in renewed periods of risk aversion. The strong local ownership base and still defensive investor positioning should also be supportive. On Russia, we adopt a market weight stance. The more uncertain fundamental outlook, continued heavy supply from the quasi-sovereign/corporate sector and investor scepticism reflected in capital outflows, balanced against the country's rock-solid debt metrics and attractive valuations versus other big EM benchmark credits argue for a neutral stance at present, in our view.

Figure 8: Hungary/Poland – vulnerable to knock-on effects from the eurozone periphery



Note: Peripheral Eurozone is an equally weighted average of Portugal, Ireland, Italy, Greece, Spain. Hungary/Poland is the two countries' average.
Source: Markit, Barclays Capital

Figure 9: Investor positioning reflects skepticism towards CEE credits in a global EM credit context



Note: Relative OWs/UWs are calculated as relative deviations from benchmark index weights (ie, normalised by country weight). Latest data available, as of 01 November 2010. Source: EPFR, Barclays Capital

MARKET OUTLOOK: LATIN AMERICA

Green light

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FX: We like the MXN and CLP, given FX flexibility, strong domestic demand (CLP) and sensitivity to US recovery (MXN). We recommend longs against a EUR and USD basket. We like short USD/PEN 2m NDF, are near-term cautious COP and think USD/BRL trades (1.70) close to its near-term lows (keep the tactical short BRL/long MXN).

Rates: We expect higher-than-priced inflation in Brazil in the next two years, so keep our long May15 NTN-B recommendation. We like 10y UF receivers in Chile, given low long-dated BE inflation amid lingering global inflation risks. A market overreaction has created opportunities in Peru's "Soberano" curve (Aug20) and Colombia's xCCY swap curve (10y receivers). Mexico's Dec25 UDIbono (where BE inflation is somewhat low) is attractive for hedging global inflationary risks.

Credit: We think spreads are in good shape to weather the US Treasury drift we are forecasting. In the high-quality space, we increase our weightings in Mexico, Colombia and Peru (we like PE50) on valuation grounds. We continue to be positive Argentina and find better value in the dollar (Boden 15 and Discount) rather than CER paper. We increase exposure in Venezuela via a default neutral basis trade (VE 23s, 28s).

FX: Long FX, diversify EUR risk

CLP and MXN: relatively cheap currencies with relatively low intervention risks

The external backdrop for LatAm FX remains supportive, with extraordinary terms of trade, abundant global liquidity and investors seeking opportunities in economies with sound macroeconomic positions. Furthermore, to the extent QE2 translates into higher inflation down the road, we believe central banks will, reluctantly, accept some FX appreciation. We expect better performance of relatively cheap currencies (Figure 1) and in those countries where authorities are more accepting of flexible exchange rates. We place the CLP and MXN in this category, with the former also benefiting from robust growth (we expect 6.1% for 2011). While Mexico's growth is expected to be mediocre (3.3% next year), the MXN looks somewhat cheap and, therefore, FX intervention does not appear imminent. Furthermore, it should benefit from the market's re-pricing of a better US growth outlook. Given a rather uncertain path of EUR/USD, we prefer longs in these currencies against a total-return volatility-minimizing basket of the EUR and USD. For the CLP, we suggest selling 65% of the notional in USD/CLP and 35% in EUR/CLP. For the MXN, the optimum basket implies 40% against USD and 60% against EUR.

Buy the CLP and MXN against a basket of the USD and EUR

Tactical opportunity in being short BRL/long MXN in the very near term

We expect the BRL to trade at 1.65-1.75 over the next several months. On the supportive side, beyond the positive global context, the clean-up of foreigners' exposures since mid-October is BRL positive. On the end of the range, USD/BRL will likely continue to face strong resistance from the authorities' eagerness to fight appreciation, especially in Q1, when inflation may not be as high. USD/BRL may not be that far from its bottom for the very near term. Hence, we still see some value in keeping our short BRL/long MXN trade (target: 7.12) as a tactical position: given diverging FX policy stances and the US economy gaining momentum, we expect the MXN to outperform.

PEN has had the second-largest overreaction to global factors: sell USD/PEN 2m forward (spot target: 2.79)

Intervention risks are high for the PEN, but it is also cheap on a real multilateral basis (Figure 1) and is the currency with the second-largest overreaction (105bp) to the rise in UST yields and to risk aversion since mid-October. This is the result of USD demand from local banks and pension funds associated with their buying of part of the USD1.5bn re-tap of the Aug20

"Soberano" (settled in USD) and the USD2.5bn issuance of the new Nov50 Global bond (mid-November). Recent dividend repatriation and a USD400m outflow (mid-October) associated with Trafigura's (a foreign commodity trading company) sale of its stake in Volcan (a local mining firm) also put upward pressure on USD/PEN. Given its low beta to EUR/USD, we recommend selling USD/PEN in the liquid 2m NDF (spot target: 2.79) to take advantage of the attractive yield differential: +0.5% (mid) versus a -0.2% average in August/mid-October.

Technicals suggest the COP's potential to outperform in the near term is limited

On fundamental grounds, we still like the COP. Yet technicals do not bode well in the near term. Banrep's steady USD purchases, together with Ecopetrol's and the Treasury's reluctance to monetize their USD inflows, have limited FX availability onshore. Additionally, local firms that issued a significant amount of USD-denominated liabilities in recent months have reacted to COP weakness of late. Efforts to cover them have added pressure on the COP. Finally, regulations requiring local banks to rebuild their USD cash holdings (which were diminished as they covered long USD/COP positions resulting from foreign investors' appetite for forward COP positions) have also put weakening pressure on the COP. The authorities appear committed to limit FX appreciation; therefore, we do not see changes in the handling of Ecopetrol and the Treasury's USD inflows. The risk remains that Banrep – in close contact with other manipulative central banks – continues with its FX intervention program beyond March, when it is scheduled to end. Also, while forward points remain negative, it is hard to see significant downward pressures on USD/COP.

Rates: Keeping it (basically) real

The combination of QE2 and domestic authorities' preference for containing nominal FX appreciation through market intervention and/or administrative measures – together with central banks' reluctance to engage in aggressive monetary tightening – suggests that inflation risks are tilted to the upside. Meanwhile, we expect structural flows to continue to be allocated to LatAm local markets.

We have analyzed breakeven (BE) inflation in LatAm against 12m ahead survey-based inflation expectations, which seem correlated with actual inflation. It is in Brazil where our bearish IPCA inflation forecast presents the largest potential for BE inflation to rise. The market is pricing less inflation over the next couple of years: 1y1y and the 1y2y BE inflation trade at 5.85% and 4.8%, respectively. Despite the 150bp of hikes we expect next year, inflation would rise to 6.3% and to 5.5% in 2012. BE inflation could, thus, rise toward 6.3-6.5% in the Aug14-Aug20 segment of the NTN-B curve.

The market is pricing more than 200bp of hikes over the next year or so; we only see 150bp

The Pre-DI curve prices almost 215bp of hikes through January 2012, followed by 115bp of cuts in the following 18m. Hikes are priced to start in January via three consecutive +50bp, +25bp in June and a 65% chance of +25bp in July. While a move in January would not surprise us, our baseline assumption is that the BCB will start hiking in March (via three consecutive 50bp hikes). Given our inflation view, we do not see much easing materializing in 2011, but doubt the market will re-price real yields much higher beyond the 2y tenor, as investors would get attracted by Brazil's level of rates if the BCB is perceived to be acting to limit further de-anchoring of inflation expectations.

With upside risks to inflation and the BCB delivering less tightening than is priced in, we recommend being long the May15 NTN-B

Considering global inflationary risks and that BCB may show greater tolerance for inflation in the upper part of the target range, we keep our long May15 NTN-B. Given risks of somewhat higher US real yields and the flatness of the NTN-B curve, reducing duration makes sense. By reducing it from the very long end towards the middle, investors can pick up yield, with the largest gain occurring in the May15 NTN-B. Uncertainty about the new government's stance on fiscal and monetary policies makes longs in short-dated Pre-DI

contracts too risky now. We would be more comfortable with longs in the Jan12s or Jan13s once policy slippage clears or at levels above 12.60%.

Low short-dated BE inflation and the timid priced in hiking path pose upside risks to short-end nominal rates; we prefer to keep our 10y UF receiver

In Chile, the market prices a marginally bearish inflation view relative to ours. We see prices growing at 3.0-3.1% in 2011-12, but the market prices 1y BE inflation at 3.25-3.2% then. These levels of forward BE inflation are just marginally above historical averages. While this may reflect BCCh's strong inflation fighting reputation, short-dated BE inflation looks somewhat low vis-à-vis lingering global inflationary risks. Also, the market is not fully pricing our base monetary policy path: hikes of 25bp per month, to 4.0% by March, before pausing through end-2011. The market prices a pause at 3.5% between January and March and the 4.0% level reached only by June. Thus, we refrain from receiving short-dated (through the 1y-2y tenors) nominal swap rates at current levels. In the long end, although 5y5y BE inflation has (since November 4) risen 50bp, to 3.25%, it still trades below the 3.5% historical average. Amid global inflationary risks, we would rather keep our 10y UF receiver. Strong paying pressure from locals in this segment of the curve appears to have subsided recently to turn technicals towards supportive territory.

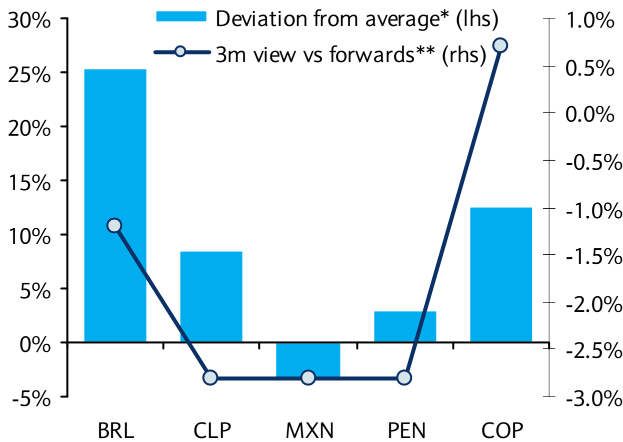
Mexico's short-end rates have begun to trade more correlated with their US counterparts; we remain cautious receivers at current levels…

The TIIE market is pricing 50bp of hikes next year. Although our base view is for Banxico to keep the policy rate at 4.5%, the aforementioned tightening is priced to materialize most likely between August and December, when "visibility" is arguably lower. Additionally, the sell-off since early November, when the TIIE market was pricing monetary easing, coincided with that of US rates. If, as Barclays Capital expects, the US recovery continues to gain momentum, the downside risks to US yields are limited. Recent price action in Mexico's rates market (and considering the country's ties to the US business cycle) suggests that short-dated yields may not have much room to decline in that scenario.

…but we like receivers/longs in the 10y and (especially) 5y sectors of the curve

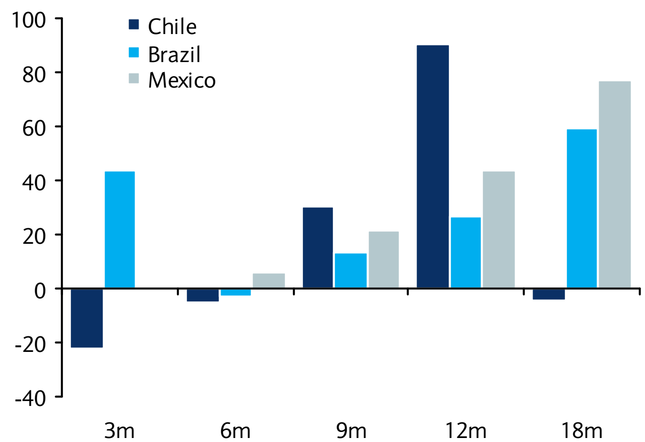
We see more attractive opportunities in mid-/long-end rates, where yields have overreacted to higher UST yields and risk aversion: 5y-10y TIIE rates trade 60-50bp above levels consistent with the re-pricing of global factors. Local pension funds appear to be already on the sidelines, saving the P&L of 2010, but we expect them to get gradually enticed early next year, especially if rates move up further. While 5y and 10y BE inflation is aligned with historical norms, global inflation risks are looming and, given their liquidity, UDIbonos could prove a sound hedge for investors. In the 10y sector of the curve, we highlight the Dec25 UDIbono, whose BE inflation trades somewhat low relative to the historical maximum.

Figure 1: Value in the CLP, MXN and PEN



*Deviation from historical average of latest real multilateral FX level. **Barclays Capital forecast deviation from forwards. Source: BIS, Bloomberg, Barclays Capital

Figure 2: Market pricing of monetary policy *



Note: *Priced-in forward path of policy rates, Barclays Capital's forecasts. Source: Barclays Capital

We like receiving Colombia's 10y xCCY swap

We also like receiving Colombia's 10y xCCY swap (target: 5.8%), which has overreacted by 70bp to the re-pricing of global risk factors, doe to paying pressure from local corporates looking to hedge FX liabilities. While carry roll-down in the 5y sector of the curve (arguably safer vis-à-vis the potentially higher sensitivity of the market to a re-pricing of UST yields) is larger (55bp for a 3m holding period) than in 10y (30bp for a 3m holding period), the former's overreaction is lower (below 30bp).

On supply-related issues, the Aug20 "Soberano" looks 40bp cheap

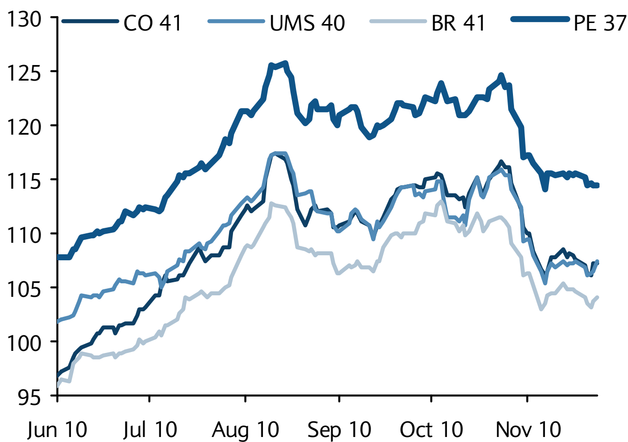
Finally, in Peru we also see some overreaction (20-40bp throughout the "Soberano" curve). Comparatively, however, the Aug20 shows a 40bp overreaction that is similar to that observed in the long end (Aug37) and well above that of its neighbour (only 10bp for the May17). This is the result of the market's digesting recent supply, so we expect it to normalize at some point. Together with PEN's attractive valuation, we recommend investors get exposure to Peru's local market through this bond.

Credit: Who is afraid?

Credit spreads in the high-quality space are closing this very volatile quarter tighter. Brazil and Panama outperformed Mexico, Colombia and Peru. Nevertheless the very sudden movement in US Treasuries originated a sharp decline in bond prices accelerated by position squaring. Inevitably, this setback has posed the question of the right timing for rebuilding a hedged long bond position and, more importantly, what effect the asymmetric risk profile of interest rates may ultimately have on credit spreads.

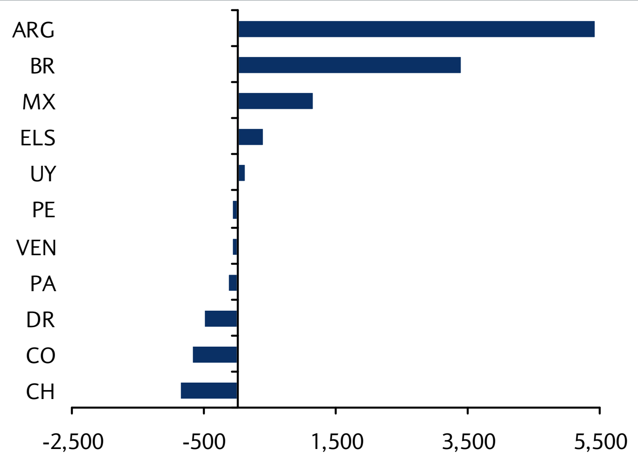
We are somewhat constructive for a numbers of reasons. First, we expect the global outlook (particularly given abundant liquidity) to remain a fertile environment for risky assets, at least over the next three months. Second, the region's strong growth outlook does not pose a threat to debt dynamics, despite a pro-cyclical increase in spending. Third, the supply outlook remains particularly supportive for LatAm credits, as we highlight in our focus piece ("Global Sovereign Credit: Less of the same, more of the new"), where we calculate that net supply is approximately -USD10bn, with Argentina, Brazil and Mexico the largest contributors. Finally, and perhaps more importantly, we think the sovereign credit market is in good shape to weather the global interest rate drift that we are forecasting. Barclays Capital is expecting a 10y Treasury yield of 3.5% by year-end. This is only 10bp wider that

Figure 3: Bond prices have been penalized by the sharp US Treasuries move



Source: Barclays Capital

Figure 4: Supply concerns are extremely limited in LatAm – net supply forecast (USD mn) *



Note: *Argentina contains GDP warrant payments; we display in the chart only selected countries; Venezuela does not include PDVSA. Source: Barclays Capital

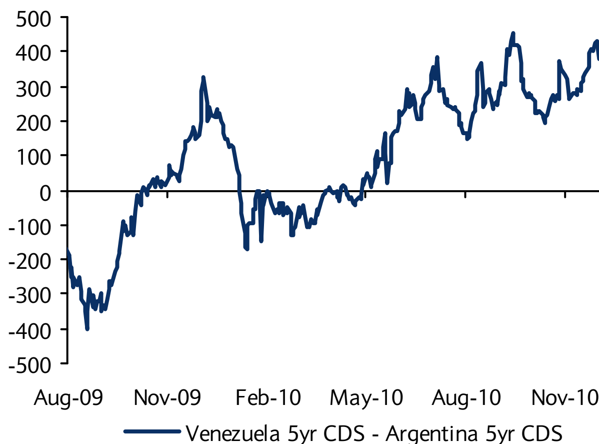
the level implied in the 10y yield 1y forward. Hence, unless the yield sell-off accelerates (not our base case scenario), we expect spreads to maintain a tightening bias.

Relative valuations, given the high correlation of spreads, are once again driving our main calls in the high-quality names. We book profits on the overweight position in Uruguay, which has become very tight; in addition, we move Panama to underweight from market weight. On the other hand, we find a tad more value in the long end of Peru's, Colombia's and Mexico's curves, especially relative to Brazil. We move these credits to market weight. In this context, we reiterate our recommendation on the newly issued Peru 50s, which trade at a good pickup to other bonds on the curve (about 80bp in yield term versus the PE33s) and other LatAm low beta names (the bond trades at an attractive 45bp over BR41s).

In the high yield space, we continue to like Argentina as an overweight. The credit has been one of our favorites in the global portfolio for some time (See *The Emerging Markets Quarterly, Sharpen your pencil,* December 2009); however, we acknowledge that valuations are becoming tighter. In particular, this seems to be the case for the CER paper, which has rallied considerably versus the USD curve. In this context, despite the carry being lower, we would prefer owning Boden 15s and the Discount versus the Bogar 18 or Peso Discount. We think the recent rally is driven by an excessive degree of optimism that inflation reporting by INDEC will normalize soon and understates FX risks. We remain positive on EUR warrants. It is still trading below the theoretical value, which we calculate at about EUR24. While we do not expect market pricing to respond much to deviations from theoretical levels, we think that the convexity of the instrument in their response to discount factors could provide room for significant additional upside.

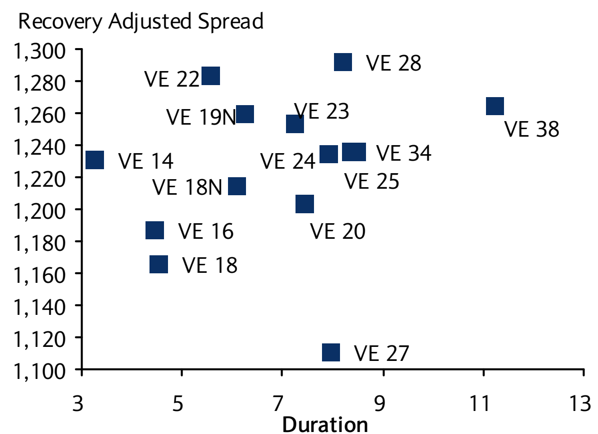
In our previous quarterly, we discussed the attractiveness of Venezuela as a credit, but remained reluctant to increase positioning, despite improving oil prices and its ability to pay. It appeared to us that investors were concerned with the uncertainty of supply and that there was limited appetite for the deteriorating fundamental story in Venezuela. Has something changed? We think so. We now expect the government to produce a devaluation of the exchange rate as early as January. This would have two important effects: it would improve fiscal and macroeconomic indicators, as well as reduce the need to increase the supply of bonds continuously. As a result, we do not expect new issuance from either PDVSA or Venezuela over the next three months (for details, please see "Venezuela: Time to build positions" in this report). Finally, and this is, in our view, the most compelling reason,

Figure 5: Venezuela credit: Ready to go?



Source: Barclays Capital

Figure 6: Venezuela's cheap bonds



Source: Barclays Capital

bond yields have reached such attractive levels that investors cannot remain indifferent any longer. The attractive valuations could also lead the authorities to undertake some liability management and even buy back some debt, perhaps as early as next quarter. We still think that a positive carry, default-neutral basis trade could result in a winning strategy from a risk-reward point of view (see *Venezuela: Brighter political outlook, higher recovery value*, 17 March 2010). We would implement the strategy using cheap low dollar price bonds, namely VE28, VE23.

EM CORPORATE CREDIT OUTLOOK

Onward and upward

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Given solid sovereign fundamentals and robust inflows to the asset class, EM corporates have had a strong 2010, with spreads tightening and issuance spiking. We expect fundamentals and technicals to remain positive drivers for the asset class in the coming year, and we hold a constructive long-term view on EM corporate credit spreads. That said, we expect EM corporates to be ambitious in 2011, with increased capex, a higher likelihood of M&A activity, and continued issuance.

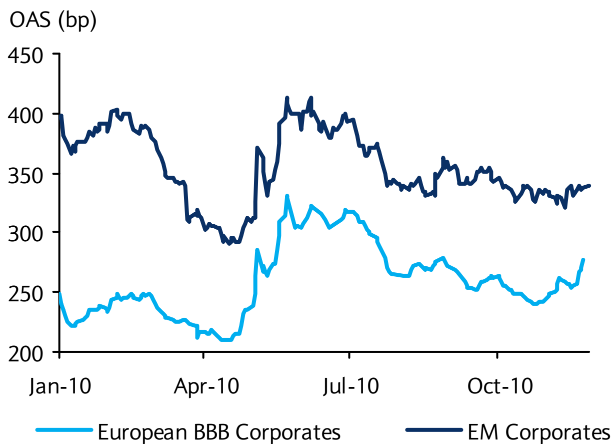
In general, EM sovereigns are fiscally – and in some cases politically – more stable than developed markets, especially when comparing LatAm and Asia with peripheral Europe. Risks from the banking systems are generally not as significant, debt levels and deficits are lower, and growth prospects are better. Corporate fundamentals are as sound as those in other regions.

Meanwhile, technicals also remain strong. Net issuance has surged but so have fund flows into EM fixed income. We believe these flows should continue; they are partly a function of a secular change in EM fundamentals. Moreover, money market funds (which feed EM inflows) are smaller than during 2008-09, but still much larger than during 2006-07.

Spreads reflected these positive drivers throughout 2010, when for the first time in our seven-year historical record, EM corporate credit spreads tightened while developed market spreads widened. After sustained outperformance over the past two years, EM valuations versus developed markets are not as compelling now. Nevertheless, spreads have room to compress if current conditions persist.

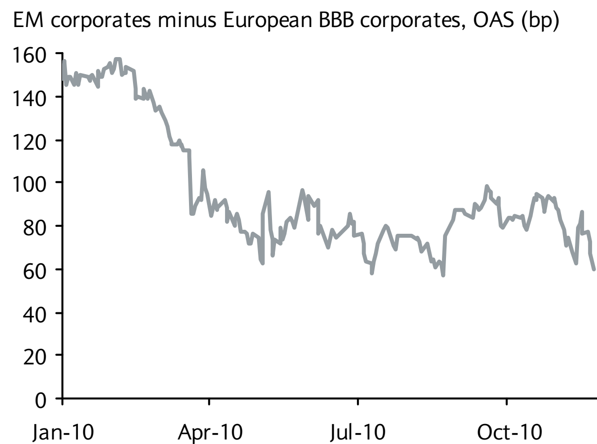
Thus, we believe EM corporate credit no longer behaves as a generic high-beta asset class. The experience of 2010 suggests that, despite higher spreads and lower credit quality, emerging market corporate credit can generate positive excess returns amid modestly widening (Europe) or unchanged (US) developed market spreads.

Figure 1: EM corporates have tightened 60bp YTD. Equivalently rated European corporates have widened 30bp.



Note: includes financials. Based on Barclays Capital Euro aggregate index and Barclays Capital USD EM index, corporate sub-index.
Source: Barclays Capital

Figure 2: The spread discount for EM credit vs equivalent rated developed corporates compressed from 150bp to 60bp



Note: We use BBB European corporates to match the average rating of the Barclays Capital USD EM corporate index.
Source: Barclays Capital

However with tighter spreads, investors will pay more attention to downside in 2011. In our view the biggest risk is a further deterioration in sentiment towards the euro area and that the peripherals-related sell-off, which has so far been contained, escalates into a global sell-off. EM credit would not be immune to this. Nevertheless, over the long run, strong fundamentals should help EM to recover faster than developed markets, as in 2009.

Unruly commodity prices, inflation, and a hard landing in China are also important considerations. That said, our economists expect contained inflation in the largest EM markets and only modest price rises for oil and other commodities. In China, we expect gradual tightening measures and for the country to grow at a high-single-digit rate. In the wake of Brazil's hike of its inflow tax, capital controls are also a risk, but the scope for similar measures in EMEA and in the rest of LatAm is limited.

EM Asia

New themes emerge as EM Asia corporates put money to work in capex, dividends, and acquisitions

We expect Asian corporates to begin 2011 with ample liquidity and an increasing appetite to expand. Looking into next year, we see several common themes across the corporate space. Even as **liquidity remains adequate**, as issuers in our universe have continued to build cash levels, we expect companies to being **searching for acquisition candidates in 2011** – already some Indonesian coal mining companies (such as Adaro and Indika) have indicated their intent to acquire coal assets. We also expect high grade Asian telcos to consider **shareholder-friendly actions** by raising debt levels. For example Axiata has announced plans to start paying dividends in 2011 and SingTel, TelMal, and PCCW may look to raise payout levels. Among the Korean quasi-sovereigns (eg, Kogas, KOLAHO), we expect **capex-related spending to increase in 2011** as they continue to build out domestic infrastructure As a result, credit metrics for the Korean quasi-sovereigns will likely continue to deteriorate. Lastly, a **sharp increase in commodity prices** would be positive for natural resource producers, but slightly negative for utility companies and tire producers.

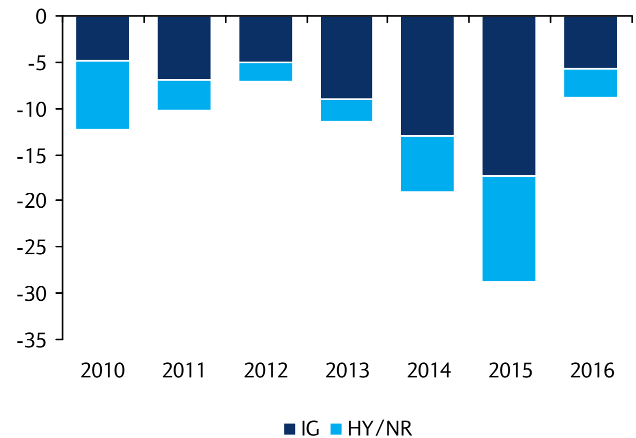
Our stable view of the Asian bank sector's fundamentals going into 2011 is underpinned by the generally benign macroeconomic outlook for the region. Looking into 2011, we expect core earnings to remain healthy, although we expect margin compression to offset the benefits of healthy loan growth.

Figure 3: Sector positioning

Overweight	Market Weight	Underweight
High Grade		
Resources	Diversified Industrials	Telecoms
	Utilities	
High Yield		
Chinese Real Estate	Resources	Utilities
Indonesian Coal	Telecom	
	Diversified Industrials	
Financials		
Financials - Bank capital	Financials - Senior	

Source: Barclays Capital

Figure 4: Corporates' estimated redemption profile (USD bn)



Source: Bloomberg, Barclays Capital

Issuance in 2011 should slow slightly, with upside risk from potential subordinated debt issuance

For 2011, we project that gross G3-currency-denominated bond issuance by Asian issuers (corporates and financials) will moderate slightly to USD50-55bn of the gross supply and USD35-40bn of net supply (versus USD43bn of net supply in 2010). However, we see upside risk to our estimate owing to potential issuance of subordinated debt, contingent on clarification of the Basel III guidelines and local regulatory interpretation. We look for increased activity in the local-currency-denominated, USD-settled corporate bond market and believe there could be up to USD10bn of issuance in this format.

Given our market view, sector fundamentals, technicals and current valuations, our sector recommendations for 2011 are: Overweight: high grade resources, Chinese real estate, Indonesian coal and bank capital securities; Underweight: high yield utilities and high grade telecoms. We recommend investors overweight Chinese real estate as a core view for 2011. We have a stable credit outlook for the sector driven by improved liquidity positions of most developers. Although we expect tightening measures to continue into 2011, we believe the market has priced in some of the likely tightening. All things considered, we believe the high carry provides adequate compensation for price volatility, and investors should be able to generate total returns ahead of the benchmark.

CIS corporates – back on a sound footing

After a jittery Q4 10, we remain cautiously constructive on EMEA corporate credit

The first two months of Q4 10 saw generally soft spread performance for most of the names in our universe. Fundamentals remained strong, with most issuers delivering Q3 10 results ahead of consensus. At the same time, the technical backdrop was weak, with new issue supply of USD12bn in October and November (versus USD20bn for the first nine months of the year together) and concerns about peripheral Europe overshadowing the recovery of fundamentals.

We expect a continuation of the above themes in Q1 11. Overall CIS corporates are coming into the new year with strong revenue outlooks and low leverage, but are relaunching their growth ambitions both in terms of capex budgets and looking for M&A opportunities. Banks' liquidity profiles have improved and capitalizations remain ample. We expect to see moderate double-digit credit growth and a rise in banks' net profit levels on the back of lower provisions and given that new NPL formation has retrenched.

In Kazakhstan, commodity-based corporates' financial performance has strengthened during 2010 (on the back of a rise in global commodity prices), which we expect to continue in 2011. Kazakh banks on the other hand have continued to focus their efforts on cleaning-up their balance sheets and enhancing their customer deposits bases (with the help of the government/GRIs) at the expense of a subdued loan growth. Their future financial performance will likely be highly dependent on the performance of the Kazakh economy as well as the recovery prospects of their NPLs.

Planned government privatizations are another interesting theme for the CIS names in 2011, likely to shape the credit-support assumptions of issuers such as VTB, Russian Rail, Sovcomflot, and KMG. However, it is our expectation that this will remain more an exercise of raising cash rather than a fundamental change in the CIS quasi-sovereign universe.

We forecast USD30-35bn of supply in 2011

We expect issuance to remain strong in 2011 and forecast gross supply of USD30-35bn, in line with USD32bn of supply in 2010 YTD. This is a net supply of c.USD20bn, leading to further expansion in the market. However, given the strong fundamental backdrop, a search for yield and resulting fund inflows, we expect the new supply to be comfortably absorbed.

The main risks continue to stem from the wider credit markets – it is hard to imagine positive returns in EM corporate credit if, for example, several European markets default or restructure and/or there is a banking crisis in the euro area. Having said this, our strategists

maintain a cautiously positive view on corporate credit generally and expect EM corporates to continue to outperform their developed market peers.

We would position at the stronger end of the HY spectrum

In this context our preference is for the stronger names in the CIS HY space – such as the telecom sector or short-dated metals and mining names. Although we are fundamentally positive on the O&G sector, we would take a neutral view on the sector's bonds – given our macro strategists' cautious stance on Russia, combined with continuing privatization noise.

GCC corporates – Dubai back on the new issue arena

We expect 2011 to mark the completion of the Dubai quasi-sovereigns' debt restructuring

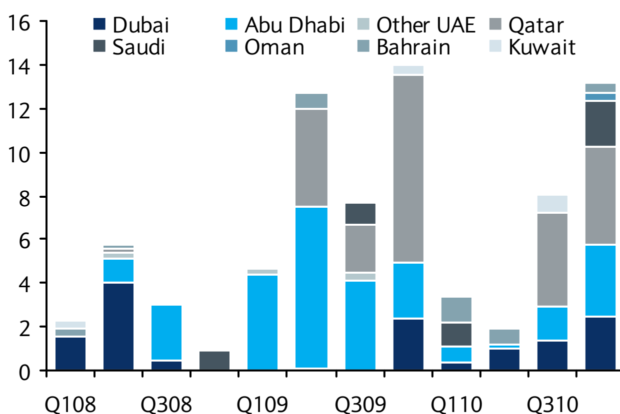
The last quarter of 2010 has seen Dubai return to the bond market, taking advantage of improved investor sentiment following the completion of the Dubai World debt restructuring. We expect a continuation of these themes in Q1 11 when Nakheel and Dubai Holding are set to complete their negotiations with creditors, followed by ICD in Q2-Q3 11.

Key drivers to watch aside from completion of the debt rescheduling include the developments in the local property markets, as well as the broader general market conditions that would allow Dubai access to the financial markets to raise funds to meet upcoming maturities, as well as realize its asset disposal programs.

GCC banks have in general had persistently slow credit growth during 2010, a trend likely to continue into early 2011 (with some exceptions in Qatar and Abu Dhabi). We expect to see a strong single-digit growth in GCC banks aggregated credit during 2011, mainly driven by government spending and government-related institutions continuous demand for funding. We expect asset quality concerns to continue to decline across GCC banks, in particular for those less exposed to the real estate sector, and provided current local macroeconomic conditions prevail or improve further and oil prices remain at decent levels. This could also result in less loan loss provision having to be set aside, leading to possible improved profitability prospects compared with 2010.

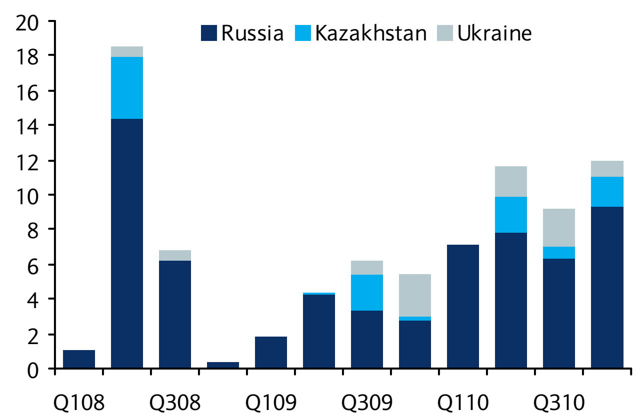
In Abu Dhabi, we are still awaiting the announcement of Aldar's refinancing program. On our estimates, the company has a c.AED10bn liquidity gap in 2011. The resolution of this problem is a key test of the sovereign support assumptions for the corporates in the emirate. We expect news flow from Qatar to remain subdued and continue to view the Qatar corporate universe as an expensive safe haven.

Figure 5: GCC bond issuance



Source: Dealogic, Barclays Capital

Figure 6: CIS bond issuance



Source: Dealogic, Barclays Capital

Aside from Aldar, we view Abu Dhabi and Qatar as relatively defensive and therefore a good proposition for investors who would like to adopt a more defensive stance. On the other hand, we continue to view Dubai as a high-beta play on the global economic recovery. We maintain our preference for the 2012 higher-yielding bonds and Mashreqbank paper in Dubai, and for Aldar and ADCB in Abu Dhabi. In the higher-quality segment of the universe, we prefer the sovereign-guaranteed bonds, TDIC and CBQ.

We expect USD25-30bn of supply

We expect the market size to increase further with new issuance of USD25-30bn from the GCC corporates and financials, a significant uptick from the USD19bn issued YTD in 2010, or a net supply of c.USD18-23bn. The growth is to be driven buy the significant investments required by the Abu Dhabi 2030 plan, M&A deals (Etisalat) and the return of the stronger Dubai corporates to the bond market following the Dubai World and Dubai Holding restructuring.

LatAm: 2010 strength to continue in the new year

LatAm corporates have issued at record levels in 2010, particularly Brazilian financials

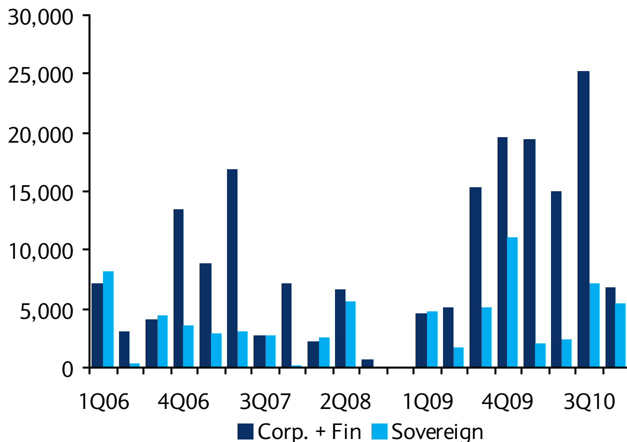
LatAm corporates maintained elevated issuance levels throughout 2010, with soaring issuance by financials leading the way. So far, financial sector issuance is more than triple last year's level at USD25.1bn. Corporates of all sectors also took advantage of open primary markets to secure long-term financing at low cost (eight perpetual deals priced so far), with some issuers pursuing diversification by printing non-USD deals.

The financial space has been especially active during 2010. Many smaller and second-tier banks have come to market during the year (representing roughly USD10bn of issuance), but we expect that trend to subside. On the other hand we should see larger financial institutions continue to seek funding in 2011, as they seek to fuel high loan growth. As such we expect total issuance from financials USD15-17bn range.

Favorable conditions should persist in 2011, allowing corporates continued access to financing

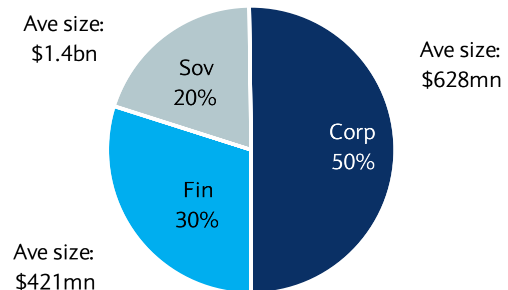
We expect favorable conditions to continue in 2011 with low rates and strong technicals, as region fundamentals remain strong. These conditions should lead to another year of significant inflows, allowing for further corporate issuance, however as some pre-funding has already occurred, we expect total gross and net issuance to be lower than that of 2010. We expect capex, M&A and new sectors to be key drivers.

Figure 7: Corporate issuance has been strong through 2010, peaking in 3Q10



Source: Bond Radar, Barclays Capital

Figure 8: 2010 LatAm corporate issuance - Large and small financials took advantage of favorable conditions



Source: Bond Radar, Barclays Capital

Based on a bottom-up analysis, we expect USD39-44bn of gross LatAm corporate issuance during 2011 (including USD6bn from new issuers), plus USD15-17bn from financials, yielding total issuance of USD54-61bn, with redemptions accounting for about USD14.7bn.

2011 issuance is likely to be driven by expansive capex plans, possible M&A activity, and new issuers

The Latin American **oil and gas sector** is expected to remain an important issuer, with collective gross issuance of approximately USD19bn from large E&P and petrochemical entities. In the **metals and mining space,** capex is expected to ramp up, and while most companies intend to fund these outlays using internal cash flow, we expect roughly USD7bn issuance for the sector. We also believe M&A activity could be a factor in issuance. In the **telecom** space, we expect issuance to be a modest USD6bn given the significant activity during 2010, but we may see some opportunistic refinancing and additional new entrants. We expect moderate issuance from food and consumer goods (USD0.5-1.0bn), while the pulp and paper sector could add USD0.8-1.0bn. We expect USD1bn of issuance from new and existing Mexican homebuilders, while utilities are likely to add another USD1bn in issuance.

We also expect new sectors/issuers from Brazil in 2011, with the homebuilders, utilities, oil service firms and infrastructure companies leading the way. Oil rig financing could be substantial, and new telecom issuers are likely to materialize (USD6bn expected).

EM SOVEREIGN CREDIT 2011 SUPPLY OUTLOOK

Less of the same, more of the new

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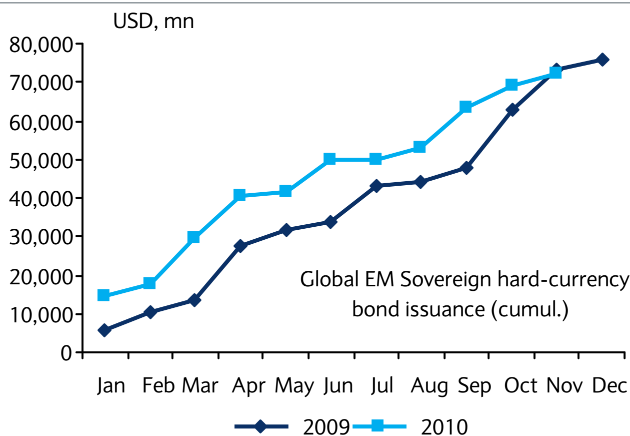
We expect total EM sovereign hard-currency supply of USD71bn in 2011, slightly less than the USD72bn supply in 2010 (Jan-Nov) and the USD76bn in 2009. A shift towards issuance in local currency is likely to result in the absence of some benchmark names from the primary credit market in 2011. However, smaller and 'exotic' issuers should partly offset the decrease in issuance from big benchmark names. The net supply dynamics look generally favourable for EM sovereign credit in 2011. The CEE region may be the most vulnerable to supply pressures and we are also concerned about high gross supply in Venezuela. In contrast, Argentina's technical supply dynamics look supportive.

EM sovereign hard-currency supply in 2010 is on track to equal the record levels in 2009, despite a slowdown in issuance activity over the past few weeks due to a heightened sense of risk aversion in light of the European debt crisis. So far this year (1 Jan- 30 Nov), USD72bn of EM sovereign hard-currency debt has been issued, compared with USD76bn in full-year 2009. We note, however, that 2010 issuance has been heavily skewed towards EMEA. While both LatAm and Asian issuance volumes have fallen compared with 2009, EMEA issuance has jumped from USD40bn in 2009 to USD52bn in 2010 (Figure 2). The pick-up in local-currency Eurobond issuance by Asian (Philippines) and LatAm (Brazil, Chile, Colombia) sovereigns, as a substitute for hard-currency issuance, partly explains these regional differences.

The shift of preference towards local currency issuance will keep some benchmark names out of the primary market in 2011

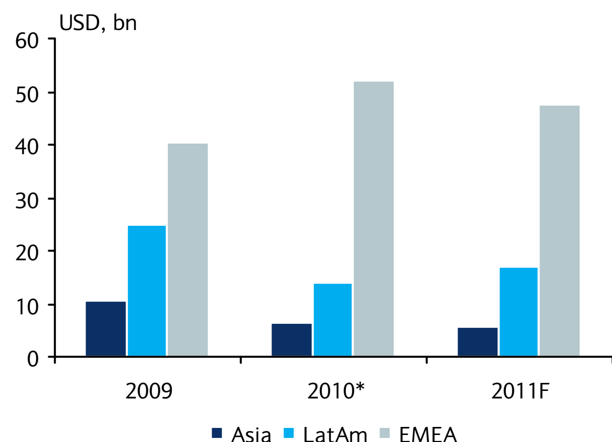
Generally, we expect the shift and preference towards issuance in local currency to continue (via domestic bonds and local currency-denominated Eurobonds). Specifically, among the big benchmark credits, we think it is unlikely that Russia will return to the hard-currency credit market next year, given the government's indications that it will seek to cover its financing needs in the local market and via the potential issuance of a RUB-denominated global bond. We also note that South Africa has scrapped its Eurobond issuance plans for the 2010-11 FY and expect Brazil to only issue USD 1.8bn in the hard-currency space. Similarly, we think Mexico is likely to continue its strategy to convert debt from USD and EUR into local-currency debt. The market has been very receptive for EM local paper this year, driven by very strong inflows into EM local bond funds. It seems unlikely that this momentum for local bond flows can fully be maintained in 2011, given the current stage of

Figure 1: Supply in 2010 on track to equal 2009 record levels



Source: Barclays Capital

Figure 2: We expect slightly reduced supply in 2011



Note: *2010 numbers are Jan-Nov. Source: Barclays Capital

the local rate cycle. This may work in favour of external debt and, given the reduced supply outlook, may provide a favourable environment for EM sovereign credit from a relative demand/supply perspective.

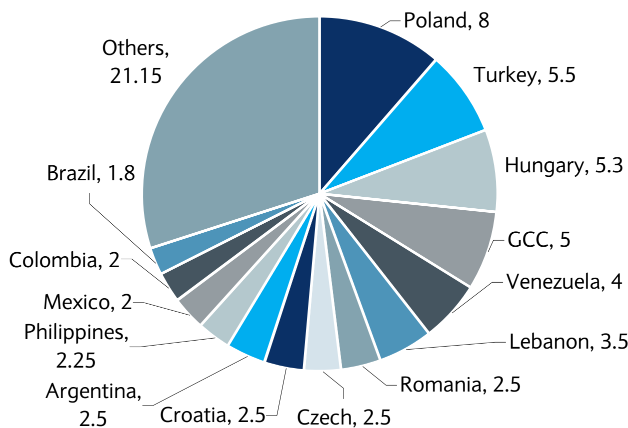
Smaller and 'exotic' countries will partly fill the gap

However, new issuance from smaller, "exotic" and frontier-market countries is likely to offset partly the reduced issuance from big benchmark names. We expect several African countries to realize their issuance plans over the coming year: Nigeria, Zambia and Kenya are among the countries for which we expect a maiden Eurobond issue. Senegal, and potentially Ghana, may return to the international capital markets in 2011, with likely new issuance from Egypt and Tunisia in North Africa also adding to the growing universe of African credit. We also note that the Dominican Republic has announced plans for a new USD750mn Eurobond next year and that Bolivia may join the ranks of issuers in the LatAm region.

While supply dynamics in Argentina look supportive, we are more concerned about Venezuela

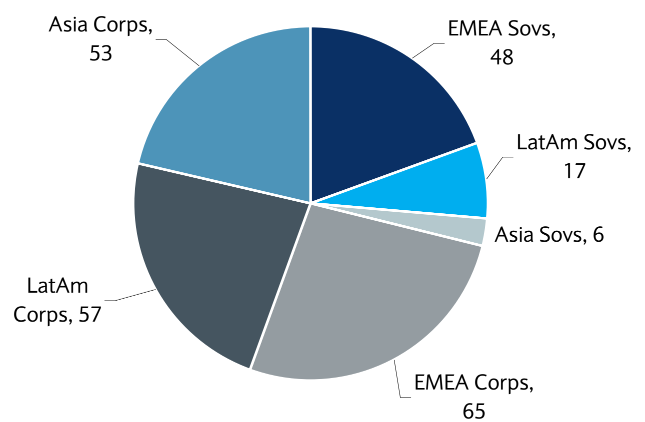
Among the high-yielding credits, Venezuela and Argentina deserve special attention as their respective supply outlooks are driven by different, idiosyncratic considerations. Argentina continues to be a net payer to the market. In our baseline scenario, the Republic will continue to rely on the central bank for support with international reserves. In 2011, we expect an even greater use of international reserves to pay not just bonds and warrants but also any Paris Club obligations that the Republic may agree to cancel. We estimate the central bank could provide support that ranges from USD10-14bn, depending on the nature of the Paris Club agreement (we always assume that the Republic will not cancel in full its obligations to the Club). After taking into consideration the significant provision of financing from the social security administration, Banco Nacion and the central bank, we would expect the Sovereign to issue only USD2.5bn in markets during 2011. Considering that the expected bond payments are about USD9.4bn (excluding warrant payments), there should be ample market capacity to absorb this gross supply. We also expect some supply to arise from near-sovereign entities such as Province of Buenos Aires, Cordoba, Neuquen and others. All in all, net market exposure to Argentina risk diminishes significantly, in our baseline scenario. In Venezuela the technical position is less compelling. The Republic's total issuance is likely to be only USD4bn in 2011, on our estimates. However, if PDVSA is included, we expect the total issuance to be around USD10bn. This compares with a total amortization and interest of approximately USD8.2bn. Net supply of USD1.8bn may not appear high, but we are concerned that the reaction of the market to the large gross supply may not be very benign.

Figure 3: Apart from Venezuela, EMEA countries will lead the sovereign primary market league tables in 2011 (in USD bn)



Source: Barclays Capital

Figure 4: Corporate/quasi-sovereign issuers are set to dominate the EM primary market in 2011 (in USD bn)



Note: PDVSA is included in LatAm corporates. Source: Barclays Capital

Net supply dynamics should be favourable for EM sovereign debt in 2011, but the CEE region seems to be in a relatively weak spot

Similar to 2010, we expect corporate/quasi-sovereigns to dominate the primary EM credit markets in 2011 (Figure 4). According to our estimates, the total amount of issuance for this area in 2011 will be USD 175bn, slightly down from USD 186bn in 2010 (Jan- Nov). The reduced EM corporate supply outlook dovetails with the favourable supply dynamics on the sovereign side. Taking into account interest payments and upcoming redemptions, our gross new EM sovereign supply estimate of USD71bn reduces to a very manageable net supply of USD12bn. Similar to gross supply, net supply will likely be skewed heavily towards EMEA. We note that LatAm and Asia are likely to have negative net supply in 2011 (Figure 5). While the manageable net supply outlook should generally be supportive for EM Sovereign credit in 2011, on a relative value basis the CEE region seems to be in a weak spot and most vulnerable to any potential supply pressures.

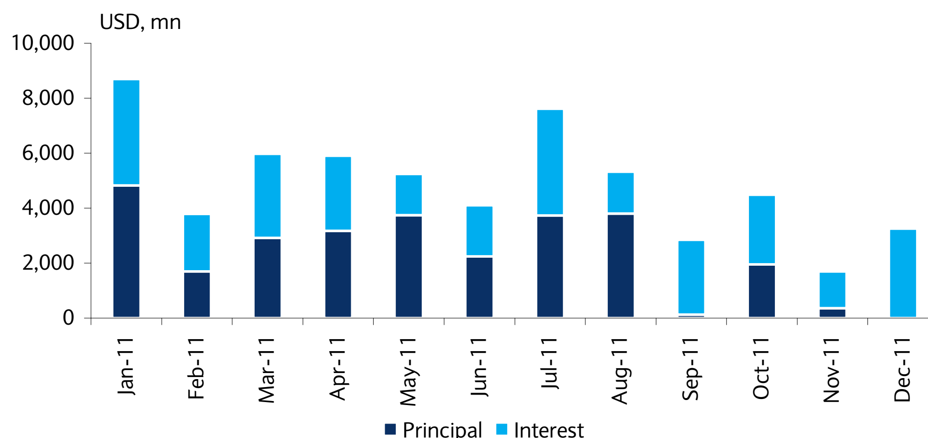
Notably, the redemption and interest payments are front-loaded in 2011 (Figure 6). The general risk environment permitting, this should create a favourable issuance environment, particularly in the first half of 2011. Given the continued low core rates, it seems likely that many issuers will use these conditions to meet their issuance needs early in the year.

Figure 5: Gross and net EM sovereign credit supply forecast 2011 (in USD bn)

	Gross supply forecast	Interest payments		Maturities		Net supply forecast
		USD	EUR (in USD bn equiv.)	USD	EUR (in USD bn equiv.)	
Asia	5.8	3.7	0.0	3.5	0.0	-1.4
LatAm*	17.1	13.9**	1.8	9.4	2.0	-10.0
EMEA	47.7	8.8	2.0	7.2	6.5	23.2
Total	70.6	26.4	3.8	20.1	8.5	11.8

Note: * does not include PDVSA ** does include Argentina GDP warrant, but does not include Global BRL, CLP and COP bonds.
Source: Barclays Capital

Figure 6: EM sovereign maturities are front-loaded in 2011



Source: Barclays Capital

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COUNTRY OUTLOOKS

EMERGING ASIA: CHINA

Managing inflation risks and growth concerns

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Next year will be a critical test of the Chinese government's policy making, as it tries to balance several near- to medium-term priorities: controlling inflation and ensuring stable growth, while adjusting the economic structure and improving income distribution. We expect GDP growth to slow to 9.3% in 2011 from 10.2% in 2010 and project CPI inflation to stay above 4.5% in H1 11. We look for a moderate tightening cycle with gradual interest rates hikes. We expect continued appreciation in the CNY versus the USD, as well as on an effective basis, with the pace depending on USD cross rates movements.

Moderate tightening cycle to anchor inflation expectation

Inflation risks rose significantly

In the September *EM Quarterly*, we discussed "rising but likely contained inflation risks" and expected "higher inflation in 2011 given upward pressures from high food and commodity prices, wage inflation and resource price reform". CPI inflation subsequently rose higher than we and the market expected, reaching 4.4% in October on surging food prices. We now look for inflation to rise further and to remain elevated in H1 11 before moderating in H2 (Figure 1). Reflecting the latest domestic and external developments, we raise our 2011 inflation forecast to 4.3%, from 3.5% in September (consensus then was 3.1%).

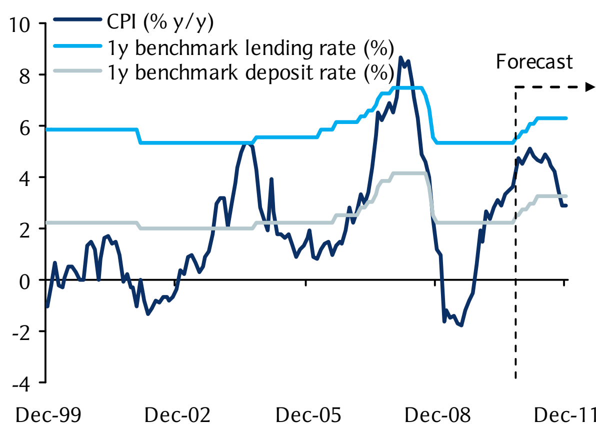
We think ample liquidity and negative real interest rates are the fundamental forces…

We view the ample domestic liquidity amid a low interest rate environment and capital inflows, as well as persistent negative real rates (Figures 1-3), as the fundamental forces behind escalating inflation expectations, speculation in food products and elevated property prices in 2010, although many forces (supply, costs, demand, and seasonal factors) have contributed to recent food prices increases. The ample liquidity reflects the huge credit expansion (CNY9.6trn in 2009, more than CNY7.5trn official plus CNY2trn off-balance-sheet loans in 2010), faster money circulation and incomplete sterilisation of capital inflows.

… exacerbated by QE2 and rising global commodity prices

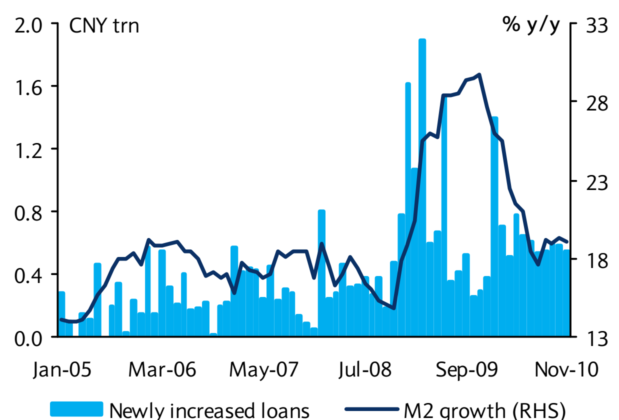
The situation has been exacerbated since September by expectations of QE2, which fuelled "hot money" inflows, and a weak USD pushing up global food and commodity prices. The PBoC's FX purchases surged to USD79bn in October (Figure 3). Moreover, while China follows a 95% "self-reliance" rule for core food produce on food security concerns, there is an increasing correlation between domestic and global food price movements (Figure 4).[1]

Figure 1: Inflation risks increased significantly



Source: CEIC, Barclays Capital

Figure 2: Large stock of broad money built up since 2009



Source: CEIC, Barclays Capital

[1] The increased correlation could be transmitted through financial market channels (eg, futures trading) as well as trade channels, and in turn affect food growers' and dealers' expectations about future prices.

The PBoC started to normalise monetary conditions…

Against this background, the PBoC increased the required reserve ratio twice in November after a benchmark rate hike in October, which highlighted the urgency to tighten liquidity (see "China: Time to further normalise monetary conditions", *Global Economics Weekly*, 5 November 2010). SAFE has also stepped up capital controls to curb speculative inflows.

… and the monetary policy stance was shifted to "prudent"

In December, the monetary policy stance was shifted to "prudent" for 2011 from "moderately loose" adopted in late 2008. The "active" fiscal policy stance was maintained. We expect fiscal policy to play a larger role in supporting growth, carrying out the necessary structural adjustments, including tax reforms. While the top policy priority for the coming quarters has shifted to controlling inflation, stabilising property prices will remain a focus (see "China: Accelerating property tightening to stabilise prices", *Global Economic Weekly*, 1 October, 2010).

These have already adjusted market expectations…

… but rate hikes are still needed

We think the targeted measures since November – to ensure adequate food supply, curb speculative trading and subsidise the poor – will help limit the increased momentum in food prices, especially in the short term. The latest PBoC moves have also adjusted market expectations, as reflected in the 10% decline in the Shanghai A share index from its peak in November. However, we continue to believe a tightening cycle with gradual rate hikes is needed to correct negative real rates and effectively anchor runaway inflation expectations.

We do not expect aggressive tightening though…

… given continued uncertainties externally and domestically

That said, we also do not expect aggressive policy tightening that would lead to a hard landing in 2011. The government demonstrated in 2010 its preference for using quantitative/administrative tools to manage inflation and asset bubble risks. It also tends to lean towards caution in balancing growth and inflation risks. External (the European debt crisis, US recovery) and domestic (a possible sharp property market correction and local government debt) uncertainties, as well as widening interest rate differentials leading to more capital inflows, will remain concerns when it deliberates interest rate moves.

We look for three rate hikes…

We therefore forecast three policy rate hikes of 25bp each through mid-2011: one before year-end and two in H1 11. This would still leave real rates in negative territory. Risks to our baseline include those to the inflation outlook, such as weather, QE needs and USD rates.

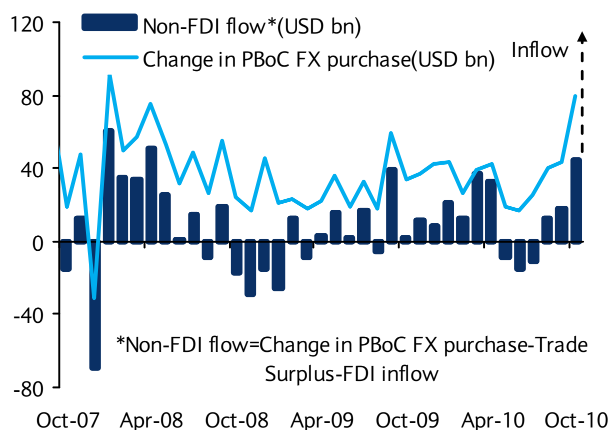
… continued administrative measures…

The PBoC will likely continue to use window guidance and RRR hikes (another 50-100bp is possible) to guide credit growth and manage liquidity. Measures to stabilise food prices will also likely remain for some time, but nationwide price controls are a small probability.

… and lower M2 and loan targets

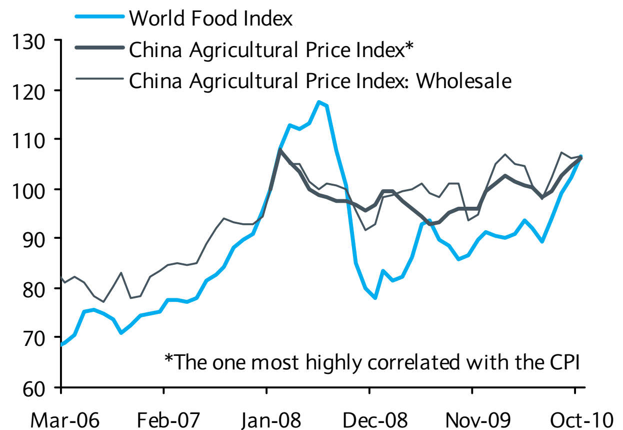
We look for a lower M2 growth target of 15-16% for 2011, versus a target of 17% and a likely actual growth close to 20% in 2010. This would require new lending of CNY6.5-7.0trn

Figure 3: PBoC's FX purchases surged on capital inflows



Note: Consistent FDI outflow data not available. Source: PBoC, Barclays Capital

Figure 4: Food prices have become more correlated



Source: IMF, MoFCOM, Barclays Capital

in 2011, compared with the target of CNY7.5trn and likely actual of CNY10trn in 2010. Nevertheless, we believe actual lending will meet China's growth needs.

Slower growth, higher inflation, but better structure

Growth remains on track to meet our 2010 forecast…

Economic developments in the past few months have moved in the direction we discussed in the September *EM Quarterly;* the slowdown in activity has stabilised, and property investment (36.5% y/y YTD) and exports (32.7%) have posted strong growth. We expect real GDP growth to moderate to 9.3% in Q4 from 9.6% in Q3 and 10.3% in Q2 (Figure 5).

… and is expected to move to a lower but still steady pace in 2011…

We look for GDP growth to slow to 9.3% in 2011 from 10.2% in 2010 (marginal revisions to our previous 9% and 10.1% forecasts). We expect the theme on growth discussed in the September *EM Quarterly* – "more balanced growth though investment will remain a key driver, while consumption growth will pick up" – to continue in 2011 (Figure 7).

… with upside and downside risks roughly balanced

Risks to our 2011 growth forecast are roughly balanced. External uncertainties and uncertain property market dynamics – a rate hike cycle may lead to some fall in property prices and negatively affect sentiment and private property investment – will continue to pose some downside risks. However, the government target of building 10mn units of public housing in 2011, compared with 5.8mn in 2010 and 3.3mn in 2009, should provide strong support to construction activity. Upside risks include stronger investment growth at the local government level (given that 2011 is the first year of the 12th Five-Year Plan), and stronger consumption growth if government policies to improve income distribution and promote consumption are able to achieve better-than-expected outcome.

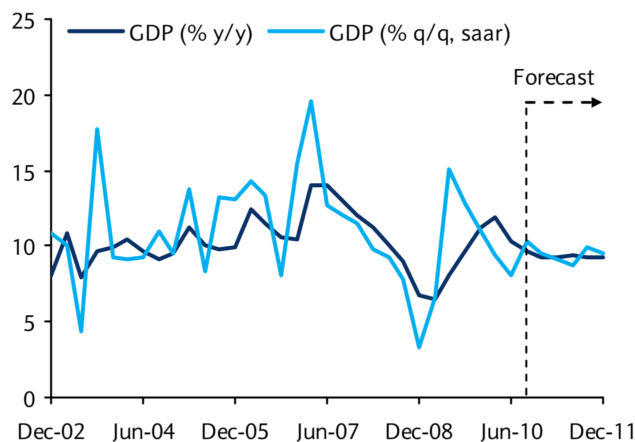
…policy changes or lack thereof warrant close monitoring

A risk to our benign outlook would be a further delay in the use of price-based tools, interest rates and the exchange rate and a continued reliance on quantitative measures. This could lead to a further build-up of the domestic distortion, external imbalance, and asset bubble, requiring more significant tightening or resulting in a painful correction at a later stage.

The 12th Five-Year Plan focuses on quality and sustainability

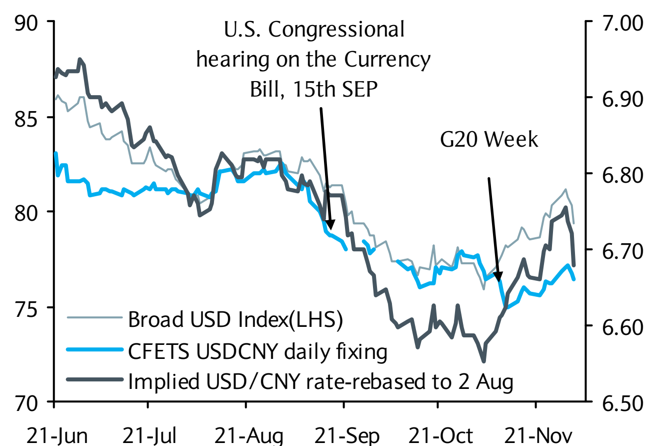
The final version of the 12th Five-Year Plan, with a draft passed by the Communist Party in October, will be approved next March. The government has set as a policy priority adjusting the economic structure and rebalancing towards consumption-led growth. Key areas of development include income distribution reform (the shares of labour compensation and household income in GDP are expected to increase), speeding up urbanisation, developing the service sector, promoting private investment, upgrading the industrial structure, developing new strategic industries, rural development, and fiscal and financial reforms.

Figure 5: We expect slower but steady growth in 2011



Source: CEIC, Barclays Capital

Figure 6: CNY appreciation depends on the USD cross rates



Source: Bloomberg, Barclays Capital

Slower growth and high inflation will be a medium-term trend

The next five years will be a critical period of development for China, given the changing domestic and external environment. Widening income inequality amid surging property prices threatens social stability, and the exports- and public investment-driven growth model can no longer be sustained. A natural factor price normalisation (land, labour, capital, resource, and environment), exacerbated by turning demographics, will increase the cost of production and add to inflation. We expect slower growth and high inflation to be a medium-term trend.

For the CNY, we expect flexibility and reference to a basket to remain a policy objective …

On the CNY, we expect reference to a currency basket (with a bias towards the USD) and flexibility to continue to be important considerations in the exchange rate formation mechanism – a medium-term policy objective, in our view. On the other hand, we would not be surprised if the government applied discretion in both directions (Figure 6), to avoid high volatility or to respond to international pressures (see *China: Market Rules - rate hike cycle and fast appreciation the only policy prescription*, 11 November 2010).

… and continued CNY appreciation, with the pace depending on USD cross rates

In the short to medium term, large BoP surpluses, real growth rate differentials versus the G3, and China's commitment to stable growth and policy point to continued CNY appreciation. This would also be in China's interest, as appreciation would help to limit imported inflation and reduce external and internal imbalances. We continue to look for moderate CNY appreciation of about 5% at an annualised pace versus the USD, or on an effective basis assuming stable USD cross rates. Risks to this view include USD movements, further QE and political pressures.

Figure 7: China macroeconomic forecasts

	2007	2008	2009F	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	14.2	9.6	9.1	10.2	9.3	9.2
Domestic demand contribution (pp)	11.1	8.8	12.8	9.9	9.1	9.2
Private Consumption (% y/y)	11.6	10.6	8.2	8.6	9.1	9.4
Gross Capital Investment (% y/y)	13.9	9.8	20.7	14.2	11.7	11.7
External demand contribution (pp)	3.1	0.8	-3.7	0.3	0.2	0.0
Exports (% y/y)	25.8	17.4	-16.0	29.3	16.7	17.0
Imports (% y/y)	20.8	18.5	-11.2	35.3	19.0	19.0
GDP (USD bn)	3,517	4,535	4,984	5,866	7,148	8,595
External sector						
Current Account (USD bn)	372	426	297	312	340	366
CA (% GDP)	10.6	9.4	6.0	5.3	4.8	4.3
Trade Balance (USD bn)	262	297	198	193	193	194
Utilised FDI (USD bn)	84	108	94	108	124	136
Gross External Debt (USD bn)	374	375	429	528	602	681
International Reserves (USD bn)	1528	1946	2399	2800	3150	3350
Public sector						
Fiscal Balance (% GDP)	0.6	-0.4	-2.2	-2.8	-2.0	-2.0
Gross Public Debt (% GDP)	15.0	15.5	17.7	20.5	22.5	24.5
Prices						
CPI (% Dec/Dec)	6.5	1.2	1.9	4.52	2.88	4.54
FX, eop	7.35	6.83	6.83	6.63	6.31	6.06
	1 yr Ago	**Last**	**Q410F**	**Q1 11F**	**Q2 11F**	**Q3 11F**
Real GDP (% y/y)	11.3	9.6	9.3	9.2	9.4	9.3
CPI (% y/y, avg)	0.7	3.5	4.6	4.9	4.7	4.5
FX (USD/CNY, eop)	6.83	6.69	6.63	6.55	6.46	6.38
Monetary Policy Benchmark Rate (%, eop)	5.31	5.31	5.81	6.06	6.31	6.31

Source: Barclays Capital

EMERGING ASIA: HONG KONG

CNH, the "dim sum" bond, and more

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The rapid development of the offshore RMB market reflects strong investor interest and proactive policy. While we would not be surprised to see further regulatory changes designed to improve the functioning of the market, the objective of promoting the international use of the RMB, driven by economic considerations, will remain intact.

Accelerated development of the offshore RMB market

The development of the offshore RMB market in Hong Kong accelerated since the last *EM Quarterly*, with surging RMB deposits, RMB trade-settlement, RMB bond issuance and a fast growing offshore RMB interbank market – also called the CNH market (for details on market participants and instruments, see *Hong Kong: CNH Market Primer*, 2 December 2010).

… following the major liberalisation in the summer

This reflects increased incentives to hold RMB offshore – higher-yield investment products and expected renminbi appreciation – following the major regulatory liberalisation in the summer, which aided the momentum of the virtuous cycle we detailed in "Hong Kong: Developing an offshore renminbi market", *The Emerging Markets Quarterly*, 21 September 2010.

We expect rapid accumulation of RMB deposits…

A prerequisite for development of the offshore market is sustained and sizable RMB liquidity. RMB deposits more than doubled between July and October, rising to CNY217bn from CNY104bn, accounting for 3.6% of total deposits in Hong Kong, compared with 1.1% at end-2009 (Figure 1). We believe they could reach 5-10% in 2011. Corporates (mostly mainland importers and exporters) as well as local residents are major sources of offshore RMB liquidity, accounting for CNY100bn and CNY50bn respectively of the CNY150bn increase in 2010 ytd.

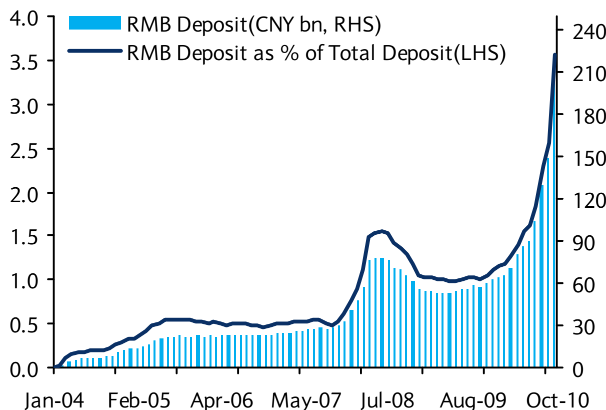
… continued increases in RMB trade settlement

The rapid rise in the RMB deposits reflects a marked increase in cross-border RMB trade settlement. Trade-settlement-related RMB remittance more than doubled to CNY69bn in October from CNY30bn in September. In fact, the rise in demand for RMB trade settlement has exceeded Chinese authorities' earlier expectations, as shown by the completion of the 2010 CNY8bn conversion quota by October. The HKMA, with a CNY200bn swap agreement with the PBoC, has the capacity to smooth market operations with RMB liquidity provision.

…and full-spectrum of RMB bond issuers and maturities

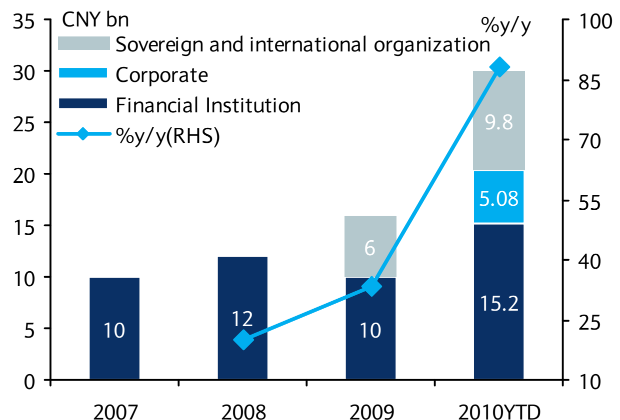
RMB-denominated bond issued in Hong Kong – or 'dim sum' bonds – have also expanded to a full-spectrum of issuers (to corporate, foreign banks and international organisations) and maturities (to 10y). The lack of onshore access and strong demand have contributed to the sometimes significant premium for offshore RMB bonds over comparable onshore bonds.

Figure 1: RMB deposit accumulation surged since August



Source: CEIC, Barclays Capital

Figure 2: RMB bond issuance expanded significantly



Source: HKMA, Barclays Capital

Figure 3: Three existing markets to trade the renminbi

Market	Nature	Daily Turnover	Average Deal Size	Spot vs USD	1y Forward vs USD
CNH	Offshore deliverable	USD500mn	USD5-10mn	6.6400	6.5850
CNY NDF	Offshore Non-Deliverable	USD2-3bn	USD20mn	NA	6.49
CNY	Onshore deliverable	USD10-15bn	USD15mn	6.6520	6.5750/6.5400*

Note: * This reflects a 2-tier market after SAFE measures announced on 9 November. Source: Bloomberg <OTC China>, Barclays Capital

… and continued expansion of the CNH market

The offshore deliverable market – the CNH market – has also seen rapid growth since its emergence in July (Figure 3). Currently, CNH FX spot, forward, swaps and cross-currency swaps are traded and the market is growing fast. For example, CNH spot trading volumes have grown to RMB400-500mn from RMB10-20mn per day in July. Due to capital controls in China, the onshore and offshore markets are not totally fungible. The limited supply of RMB relative to the large offshore demand had led to a premium for the CNH (for as much as 1700pips when CNY appreciation expectations were high) over the offshore CNY (Figure 4), though any large spread will attract sellers of CNY and lead to some convergence.

We expect growth to rise to 6.6% before slowing to 4.6% …

On the economic front, we raise our 2010 GDP growth forecast to 6.6% from 6.1% to reflect the strong Q3 outturn of 6.8% y/y. The economy should continue to benefit from easy US monetary conditions and the strength of growth in China. We raise our 2011 growth forecast to 4.6% from 4%, reflecting the stronger-than- expected momentum in H2 10.

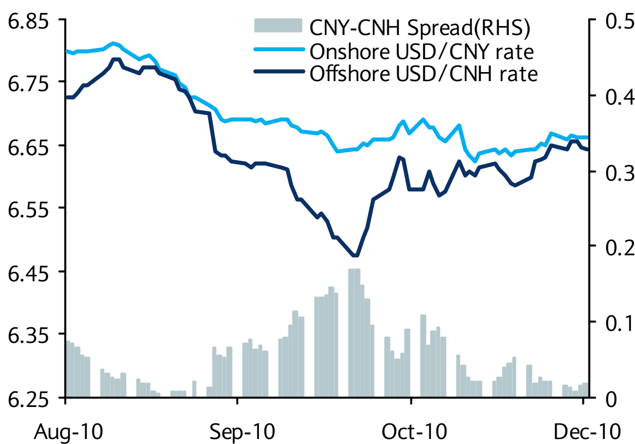
… and look for higher inflation and prudential measures to control asset bubble risks

CNY appreciation and capital inflows amid QE2 have added to inflation and asset bubble risks. The continued surge in property prices (Figure 5) triggered another round of property cooling measures from the government in November, including a three-tier stamp duty for property resales to curb speculation. Further prudential measures are possible, but we do not expect capital controls to be imposed. We maintain 2010 CPI inflation forecast at 2.5% but increase our 2011 forecast to 3.3% on higher imported inflation and housing costs.

The HKD will likely remain close to the strong side of the convertibility undertaking

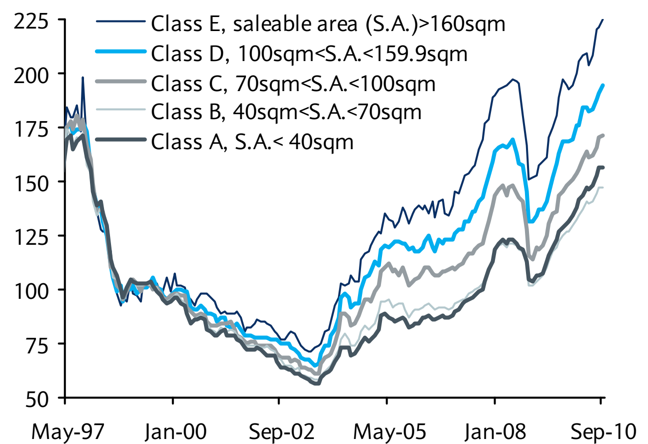
We continue to expect the HKD to hover at the current level of 7.77-7.76 in the coming months, with small upside risk towards the strong side of the convertible undertaking. The HKD strengthened towards 7.75 since September on a pick-up in the equity market amid QE2 expectations before weakening in November when eurozone sovereign debt crisis deepened (Figure 6). The prospects for the US recovery, outlook for eurozone peripheral countries and expectations of CNY appreciation (Figure 7) will continue to affect the HKD.

Figure 4: Onshore-offshore CNY rates converged recently



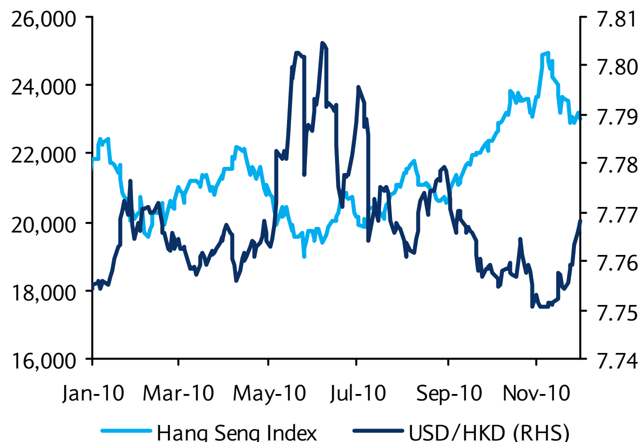
Source: Bloomberg, Barclays Capital

Figure 5: Luxury property prices surpassed the 1997 peak



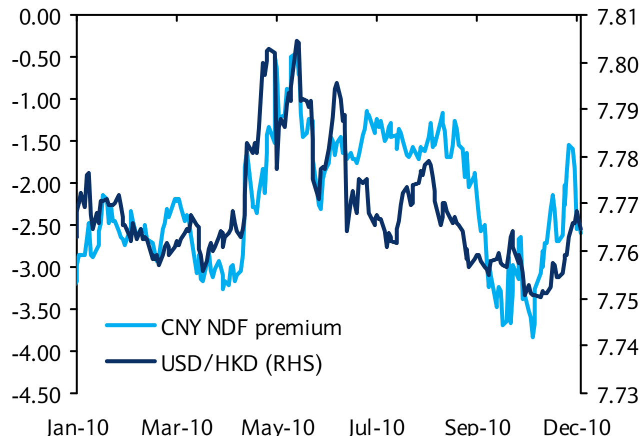
Source: CEIC, Barclays Capital

Figure 6: HKD moves along with the local equity market…



Source: Bloomberg, Barclays Capital

Figure 7: … and tracks the CNY NDF premium



Source: Bloomberg, Barclays Capital

Figure 8: Hong Kong macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.4	2.2	-2.8	6.6	4.6	4.0
Domestic demand contribution (pp)	7.0	1.4	0.8	5.4	3.8	3.2
Private consumption (% y/y)	8.5	2.6	-0.4	6.1	5.2	4.6
Gross fixed capital formation (% y/y)	3.4	1.3	-1.2	7.2	6.1	3.7
Net exports contribution (pp)	-0.7	0.7	-3.6	1.2	0.8	0.8
Exports (% y/y)	8.4	2.9	-10.3	19.4	9.4	8.6
Imports (% y/y)	9.1	2.6	-9.0	19.6	9.5	9.3
GDP (USD bn)	207.1	215.2	210.6	230.3	251.0	271.0
External sector						
Current account (USD bn)	25.5	29.3	18.3	18.8	20.6	21.7
CA (% GDP)	12.3	13.6	8.7	8.2	8.2	8.0
Goods balance (USD bn)	-23.5	-25.9	-28.9	-35.6	-35.9	-36.3
Net FDI (USD bn)	-6.7	9.1	-3.8	-1.0	0.0	0.0
Other net inflows (USD bn)	0.7	-8.6	58.9	2.5	-0.6	-0.7
Gross external debt (USD bn)	711.9	663.2	672.6	693.6	718.6	748.6
International reserves (USD bn)	152.7	182.5	255.8	276.1	296.1	317.1
Public sector						
Public sector balance (% GDP)	7.5	0.1	0.8	1.6	-1.4	0.0
Gross public debt (% GDP)	1.3	1.0	0.7	0.6	1.2	1.2
Prices						
CPI (% Dec/Dec)	3.8	2.0	1.3	3.6	2.9	1.7
FX (USD/HKD, eop)	7.80	7.75	7.75	7.77	7.76	7.78
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	2.5	6.8	4.9	4.3	4.1	4.7
CPI (% y/y, avg)	1.3	2.3	3.3	3.5	3.6	3.7
FX (USD/HKD, eop)	7.75	7.77	7.76	7.77	7.77	7.76
Monetary policy benchmark rate (%, eop)	0.50	0.50	0.50	0.50	0.50	0.50

Source: Barclays Capital

EMERGING ASIA: INDIA

Fine-tuning exit, managing liquidity

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India continues to enjoy healthy growth driven by domestic demand. The momentum in core inflation is turning softer, allowing the RBI to signal a pause. Managing tight liquidity is a challenge. The fiscal situation has improved in recent months, and the INR is set to underperform, given the weak current account and the paucity of core capital inflows.

Domestic demand stays strong, investment key to future growth

India continues to enjoy healthy growth driven primarily by domestic demand. Even as manufacturing is slowing following a large cyclical surge, GDP continues to surprise to the upside, backed by strong growth in services and agriculture. Consumption demand remains broad-based reflecting stronger rural incomes and steady consumer confidence. While private consumption should provide stability for growth, a further pick-up in GDP will depend critically on an uptick in investment. Steady demand, combined with modest capex in recent years, suggests investment will pick up in near future. However, headwinds, including the strain on domestic banking sector liquidity, rising borrowing costs, negative news about alleged high-level corruption and global uncertainties, cannot be ignored.

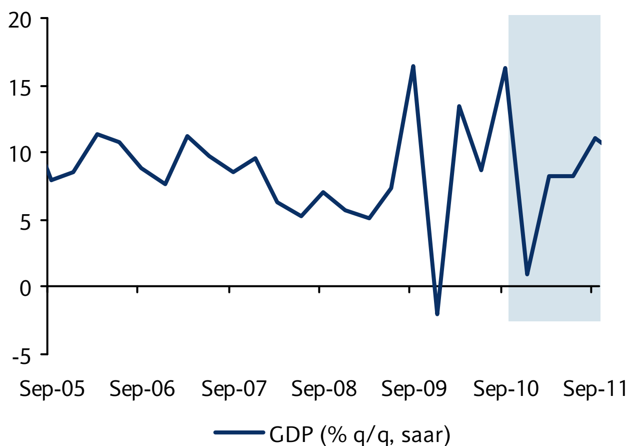
Inflation prints set to fall closer to mid-single digits

Headline inflation remains above the RBI's comfort zone. However, the near-term momentum in core inflation has turned softer. The ongoing harvest of summer crops should start influencing food prices favourably as well. Global commodity prices remain a source of uncertainty, especially post-QE2. Nevertheless, on balance, we expect headline inflation prints to soften towards mid-single digits over the next few months.

RBI on hold, adopts a more balanced policy

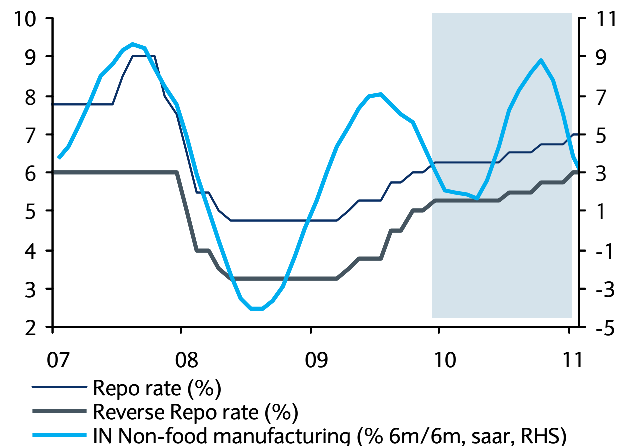
This easing of inflation has allowed the Reserve Bank of India (RBI) to signal a pause after six policy rate hikes during 2010. We believe the emerging growth-inflation dynamics will vindicate the central bank's wait-and-watch policy. We do not see a case for further generalised rate action during the remainder of FY 11 (to end-March). Policy tightening, if any, is likely to be more nuanced and targeted towards sectors showing incipient signs of overheating – similar to those seen at the November policy meeting. In sum, the RBI's policy priority is shifting from the exclusive emphasis on combating inflation seen during most of 2010. In our view, managing liquidity and supporting growth are set to emerge as important policy considerations, though the RBI will continue to monitor inflation closely.

Figure 1: Growth momentum remains robust



Source: CEIC, Barclays Capital

Figure 2: Near-term moderation in core inflation momentum



Source: CEIC, Barclays Capital

Liquidity management a key concern; RBI to inject liquidity as and when inflation prints soften

Given the prolonged strain on domestic banking system liquidity since mid-2010, liquidity management has become important for the RBI in order to ensure the smooth functioning of financial markets and avoid any premature disruption of the investment cycle. Recently, the RBI adopted several short-term palliative measures to ease liquidity. However, the current tight liquidity is not just "frictional" (ie, short-term in nature) – it is being influenced heavily by structural factors, such as the sub-optimal expansion of reserve money, persistently high unutilised government cash balances and continued leakage from the system in the form of elevated currency demand. In our view, while the RBI cannot dilute its public focus on combating inflation, internally it likely recognises the need to support system liquidity and, thereby, credit and capex over the medium term. Once inflation moves closer to the RBI's comfort zone, we expect the central bank to start to expand its balance sheet, thereby injecting a larger quantum of primary liquidity into the system.

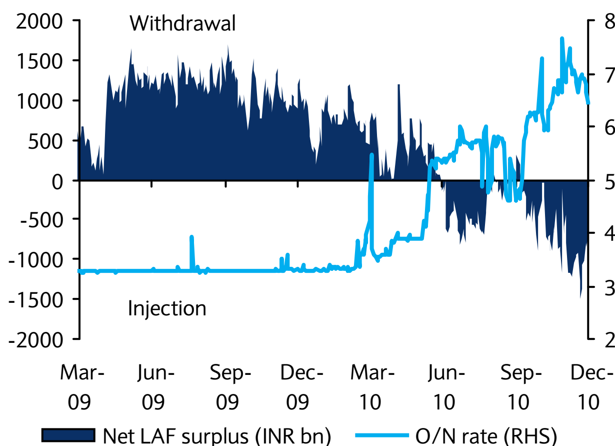
Fiscal situation improves; further gains depend on subsidy burden, success of GST, DTC and the disinvestment programme

The fiscal situation has improved considerably in FY 10-11 with buoyant revenue, large proceeds from the telecom auctions, the successful divestment of public companies and, apparently, lower subsidies following reforms in domestic energy prices. Government spending has also been relatively modest. The improvement in the fiscal picture is reflected in the token reduction in FY 10-11 borrowing plans. The typical strong pro-cyclicality of India's fiscal dynamics suggests further improvement in the fiscal balance during FY 11-12, as robust economic activity leads to stronger revenue accretion and reduces the need for discretionary government spending to support the economy. However, improvement in the fiscal situation in FY 11-12 will depend on a variety of factors, including: 1) a possible surge in global commodity prices that results in a heavier subsidy burden; 2) the effectiveness of tax reforms, such as the new Direct Tax Code (DTC) and the new, integrated Goods and Service Tax (GST); and 3) further progress in the ongoing disinvestment process. The absolute borrowing amount is, nevertheless, set to stay elevated in FY 11-12 as well.

The INR to underperform reflecting the weak current account and a paucity of "sticky" capital inflows

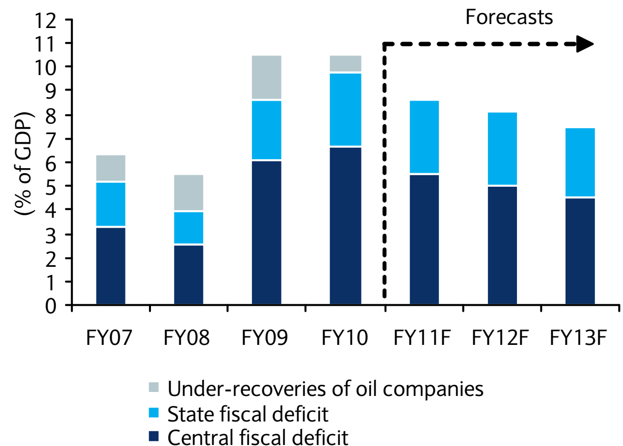
The INR has experienced large swings in recent months, which reflect fluctuations in equity market sentiment and the resulting volatility in FII flows, and fluctuating global sentiment on the USD. However, the relatively "sticky" flows, such as foreign direct investment (FDI) and external commercial borrowing (ECB) remained relatively subdued. Moreover, the current account deficit is set to widen from USD38.4bn (2.9% of GDP) in FY 09-10 to about USD53.7bn (3.3%) in FY 10-11, driven by strong domestic demand and rising imports. Accordingly, we expect the INR to underperform its EM peers in the near to medium term.

Figure 3: Liquidity strain putting pressure on interest rates



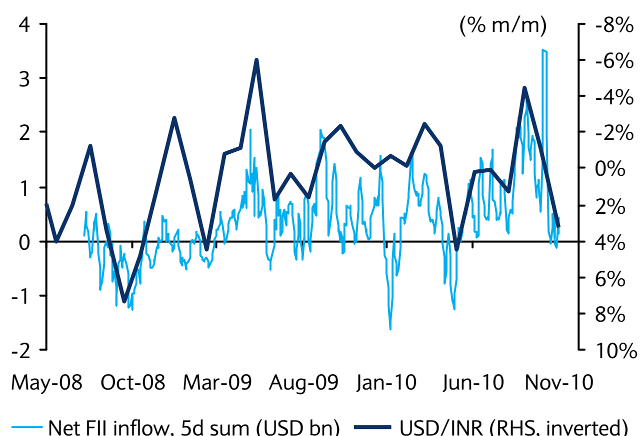
Source: CEIC, Barclays Capital

Figure 4: Fiscal position recovers



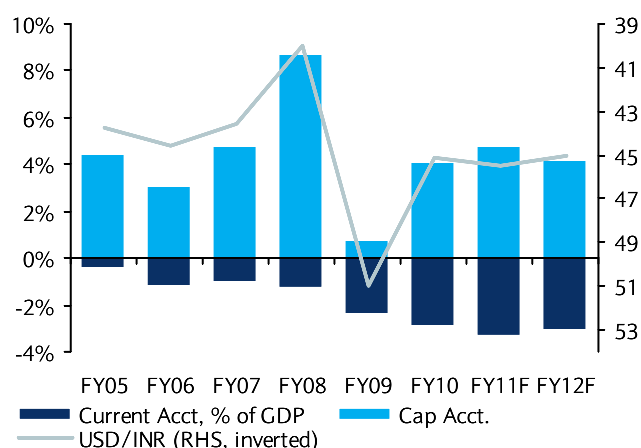
Source: CEIC, Barclays Capital

Figure 5: Short-term inflows are dictating INR strength



Source: CEIC, Barclays Capital

Figure 6: But medium-term BoP dynamics remain weak



Source: CEIC, Barclays Capital

Figure 7: India macroeconomic forecasts

	FY 07-08	FY 08-09	FY 09-10F	FY 10-11F	FY 11-12F	FY 12-13F
Activity						
Real GDP (% y/y)	9.2	6.6	7.8	8.6	8.6	9.0
Domestic demand contribution (pp)	12.1	4.9	7.1	9.8	8.8	9.8
Private consumption (% y/y)	9.8	6.9	4.7	7.8	7.5	8.1
Fixed capital investment (% y/y)	15.2	3.5	8.7	12.2	11.3	12.6
Net exports contribution (pp)	-1.4	-1.9	1.1	-0.7	-1.0	-0.7
Exports (% y/y)	5.2	19.5	-6.0	11.3	11.5	17.4
Imports (% y/y)	10.0	23.2	-8.3	11.8	13.2	16.5
GDP (USD bn)	1233	1201	1316	1606	1839	2109
External sector						
Current account (USD bn)	-15.7	-28.7	-38.4	-53.7	-56.0	-65.0
CA (% GDP)	-1.3	-2.4	-2.9	-3.3	-3.0	-3.1
Trade balance (USD bn)	-91.5	-118.7	-117.3	-136.2	-143.0	-160.0
Net FDI (USD bn)	15.4	17.5	19.7	12.7	20.0	35.0
Other net inflows (USD bn)	92.6	-8.4	33.9	64.5	57.0	58.0
Gross external debt (USD bn)	224.8	224.0	261.5	277.0	295.0	315.0
International reserves (USD bn)	309.7	252.0	279.6	290.0	315.0	345.0
Public sector						
Public sector balance (% GDP)	-5.5	-10.5	-10.5	-8.6	-8.1	-7.0
Gross public debt (% GDP)	85.6	81.0	80.0	80.0	78.0	75.0
Prices						
WPI (% Dec/Dec)	4.0	6.6	7.0	6.6	6.4	6.5
FX, eop	40.1	51.0	45.1	45.5	45.0	44.0
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	8.70	8.90	9.7	8.4	8.3	7.0
WPI (% y/y, eop)	1.50	8.6	6.6	5.7	5.9	6.1
FX (domestic currency/USD, eop)	46.57	44.72	46.00	45.50	45.50	45.50
Repo rate (%, eop)	4.75	6.25	6.25	6.25	6.50	6.75
Reverse repo rate (%, eop)	3.25	5.25	5.25	5.25	5.50	5.75

Source: Barclays Capital

EMERGING ASIA: INDONESIA

Bank Indonesia: Reactionary, not precautionary

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Bank Indonesia remains dovish, and we expect the central bank to avoid rates hikes for as long as possible. We expect the current account surplus to shrink in 2011, providing a less favourable backdrop for the IDR, and we maintain our 12-month USD/IDR forecast of 9,200. We expect FDI to become a driving force of the capital account.

BI remains dovish and willing to look through supply-driven spikes in inflation…

Bank Indonesia remains dovish. The central bank continues to state that the 6.5% policy rate is consistent with achieving an inflation target of 4-6% in 2010 and 2011. Our sense is that although monthly inflation prints remain a key input for policy, BI is increasingly looking at what is driving inflation, with a bias to look through supply-driven spikes in inflation. In terms of the policy mix, we believe the central bank has a bias to use liquidity management tools rather than the policy rate. This is driven by BI's concerns that a rate hike would further widen interest rate differentials and attract additional "hot money" inflows. We believe the central bank will avoid raising interest rates for as long as possible and expect any rate hikes to be reactionary rather than precautionary in nature.

… rate hikes to be reactionary not precautionary in nature

Policy biased towards liquidity management…

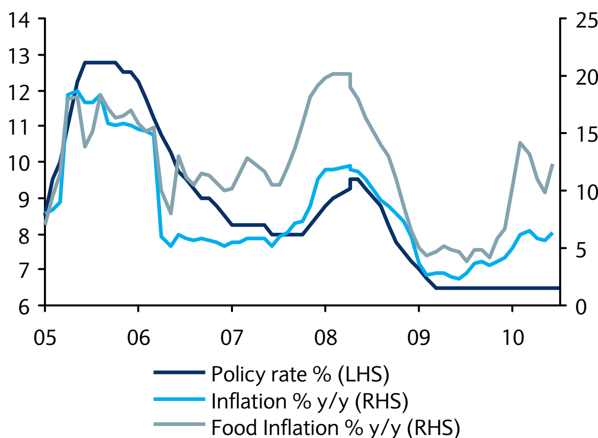
We think the first line of defence will be liquidity withdrawal and expect BI to hike the dollar reserve requirement 100bp, to 2%, in Q1 11 and lengthen the maturity of the term deposit facility to lock in additional liquidity for a longer duration. Further adjustments to the primary reserve requirement of 8%, as well as a conversion of the 2.5% secondary reserve requirement to cash from bonds, cannot be ruled out. However, BI may be forced to raise rates by at least 25bp in Q2 to ensure that inflation expectations remain anchored. BI has also mentioned macro-prudential measures to manage capital inflows. We believe the central bank is alluding to holding-period restrictions on SBIs and think an extension of the minimum holding period to three months from the current 28-days is likely.

… although BI may be forced to raise rates to anchor inflation expectations

Inflation spikes higher on food

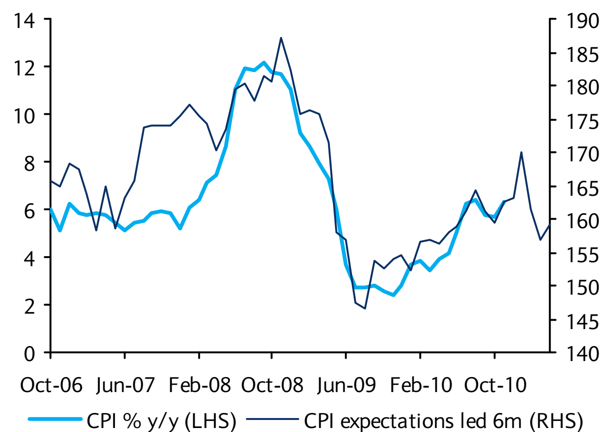
Inflation spiked to 6.3% y/y in November, driven by rising food prices, especially for rice and chillies. We expect food prices to remain elevated in Q1 given high global food commodity prices and seasonal factors, but then moderate as harvesting gets underway in March-April. Across the region, as well, wetter soil (on account of the current La Niña weather pattern) may mean that the summer harvest is better. We expect core inflation to continue rising gradually in 2011, given relatively robust domestic demand. Wage growth also remains

Figure 1: Policy looking through spike in food inflation…



Source: CEIC, Barclays Capital

Figure 2: … however inflation expectations may force BI's hand



Source: CEIC, Barclays Capital

We expect headline inflation to hit 7% by March/April

robust with rises of 10-15% across the country in Q4 2010. Administered price adjustments pose an upside risk to inflation, with the government planning to reduce the supply of subsidised fuel. According to our estimates, the reduced supply can directly add 50-80bp to inflation on a staggered basis. There will also be second-round effects, as higher transport prices feed through into core inflation. However, our base case is that the government will find it hard to push through the reform fully, especially in the face of already rising inflation. Overall, we expect headline inflation to hit 7% by March-April but then subside, as the weather-related boost drops out of y/y comparisons, before picking up in Q4 to end 2011 at around 6%.

Revising down our growth projections to 6.0% in 2010 and 6.5% in 2011

GDP growth moderated to 5.8% y/y in Q3 from 6.2% in Q2. However, we do not believe the slowing is a cause for concern as it was largely caused by weather-related disruptions to agriculture, mining and construction. We expect activity to pick up in Q4, in line with high-frequency indicators, such as consumer confidence and motorcycle sales. We are revising our GDP forecasts marginally lower: to 6% from 6.3% for 2010, and to 6.5% from 6.8% for 2011. The 2011 revision reflects higher inflation, which is dampening domestic demand.

USD/IDR to drift to 9,200 by Q4 11

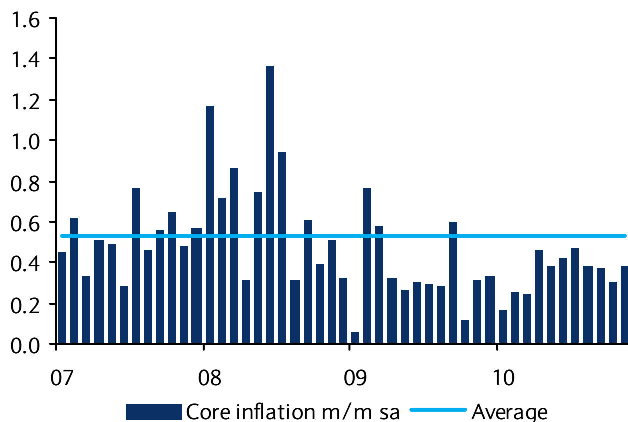
We continue to expect USD/IDR to end 2011 at 9,200 as fundamental support for the IDR weakens. We expect the current account surplus to shrink to 0.5% of GDP in 2011 from 1.1% in 2010. However, with BI indicating a willingness to use IDR strength to lean into imported price pressures, we recently lowered our three- and six-month USD/IDR forecasts to 8,900 and 9,000 respectively (see *Bank Indonesia: More liquidity withdrawal to come*, 3 December 2010).

Foreign direct investment is taking off…

… as firms relocate to Indonesia and the resource sector attracts investment from China and India

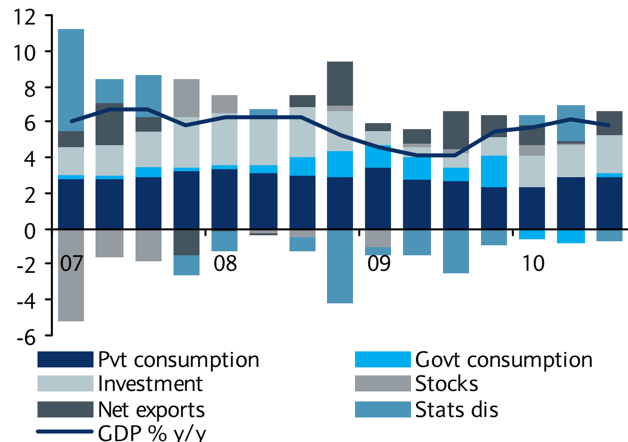
Foreign direct investment is finally taking off – Indonesia received USD6.8bn in net FDI in 9M 10. A number of forces are interacting here. Rising labour costs in China are encouraging manufacturers (including Nike, New Balance and Panasonic) to relocate to Indonesia, especially in the textiles, textile products (eg, shoes) and electronics sectors. Also, India and China continue to invest in Indonesia to secure access to resources, especially coal. At the same time, the efforts of Indonesia's Investment Commission Board, as well as a growing realisation that Indonesia has the world's fourth-largest population and a growing middle class, are attracting more FDI partners. We believe the importance of FDI in the capital account will continue to increase. This is a positive for the country's sovereign credit ratings, and we expect S&P and Moody's to upgrade the sovereign by one notch, to BB+, in 2011.

Figure 3: Core inflation to continue rising gradually



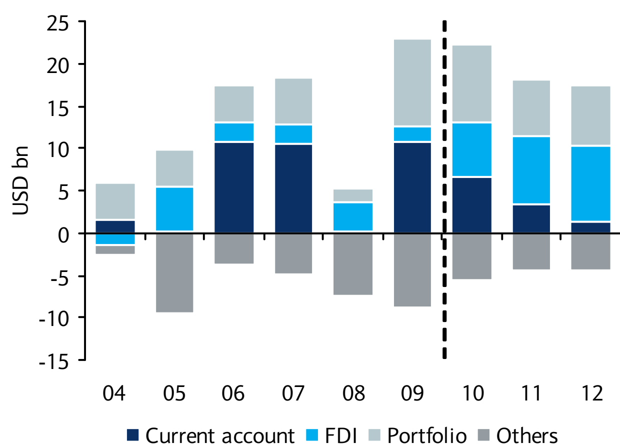
Source: CEIC, Barclays Capital

Figure 4: Domestic demand to remain the driver of growth



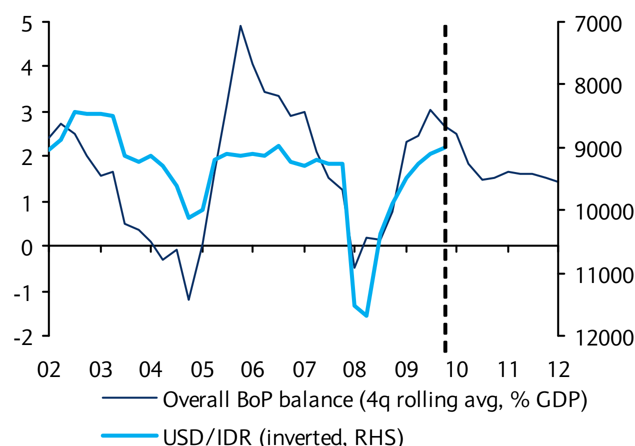
Source: CEIC, Barclays Capital

Figure 5: FDI to be a key driver of capital account



Source: CEIC, Barclays Capital

Figure 6: Lower overall balance of payment surplus



Source: CEIC, Bloomberg, Barclays Capital

Figure 7: Indonesia macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.3	6.0	4.5	6.0	6.5	6.7
Domestic demand contribution (pp)	3.7	6.7	4.7	4.9	6.5	6.8
Private consumption (% y/y)	5.0	5.3	4.9	4.9	5.5	5.6
Fixed capital investment (% y/y)	9.3	11.9	3.3	8.7	12.0	12.5
Net exports contribution (pp)	0.6	0.7	1.2	0.7	0.1	-0.1
Exports (% y/y)	8.5	9.5	-9.7	13.1	9.4	10.0
Imports (% y/y)	9.1	10.0	-15.0	15.2	11.8	13.0
GDP (USD bn)	431	507	542	702	789	858
External sector						
Current account (USD bn)	10.5	0.1	10.7	7.5	4.0	1.2
CA (% GDP)	2.4	0.0	2.0	1.1	0.5	0.1
Trade balance (USD bn)	32.8	22.9	35.1	36.5	35.1	32.9
Net FDI (USD bn)	2.3	3.4	1.9	8.8	9.1	10.0
Other net inflows (USD bn)	0.8	-5.5	1.5	10.4	4.0	2.8
Gross external debt (USD bn)	137	149	173	196	202	210
International reserves (USD bn)	56.9	51.6	66.1	92.3	108.4	121.3
Public sector						
Public sector balance (% GDP)	-1.3	-0.1	-1.6	-1.0	-1.3	-1.3
Primary balance (% GDP)	0.8	1.7	0.6	1.2	0.7	0.5
Gross public debt (% GDP)	35.0	32.9	28.2	25.8	25.8	25.4
Prices						
CPI (% Dec/Dec)	6.0	11.1	2.8	6.5	6.0	5.6
FX, eop	9,419	10,950	9,400	9,000	9,200	9,400
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	5.4	5.8	6.5	6.6	5.9	6.8
CPI (% y/y, eop)	2.8	5.8	6.5	7.0	6.6	5.5
FX (domestic currency/USD, eop)	9,400	8,924	9,000	8,900	9,000	9,100
Overnight policy rate (%, eop)	6.5	6.50	6.50	6.50	6.75	6.75

Source: Barclays Capital

EMERGING ASIA: KOREA

Containing imported inflation

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We believe supportive currency fundamentals – mounting current account surpluses – will reassert themselves. Coupled with rising imported price pressures, we maintain our view that USD/KRW will drift lower, towards 1,025 in 12m. As a hedge against geopolitical tail risks, we recommend buying 5y CDS on the Korea sovereign.

Rising imported inflation – not from food, but from rising costs in China

Imported inflation will be a stronger theme in Korea in 2011. There is emerging concern among senior policymakers that as labour costs in China start to rise, China could export inflation to Korea, even as external demand wanes. Indeed, China has already implemented policies this year to raise the minimum wage by 12-29% in a dozen provinces, with more to come in 2011. The 12th Five-Year Plan is likely to target real wage growth. We believe there is scope for further KRW appreciation – at least in line with other Asian currencies – to ward off the expected rise in imported inflation pressures.

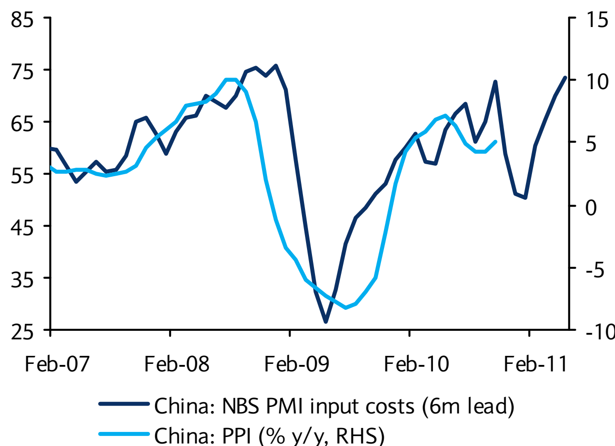
The balance of payments continues to be supportive of further KRW strength

A key factor of support for the KRW is the balance of payments. We now expect a larger current account surplus of USD32bn in 2010, a significant jump from our earlier projection of USD22bn in the previous *EM Quarterly*. Our revision was driven by a pick-up in exports in October on pre-festive season shipping to G3 markets, as well as lower imports. In reaction to the global electronics slowdown, electronics companies have started to reduce inventories and imports of intermediate components. At the same time, exports continue to hold up, helped by rising vessel and auto shipments. This has contributed to the widening of the trade surplus since August. For the first 10 months of the year, the cumulative current account surplus was USD29.1bn – a shade below the government's recently revised projection of USD30bn for 2010. Our projection is now USD32bn, with modest upside risks.

KRW remains undervalued

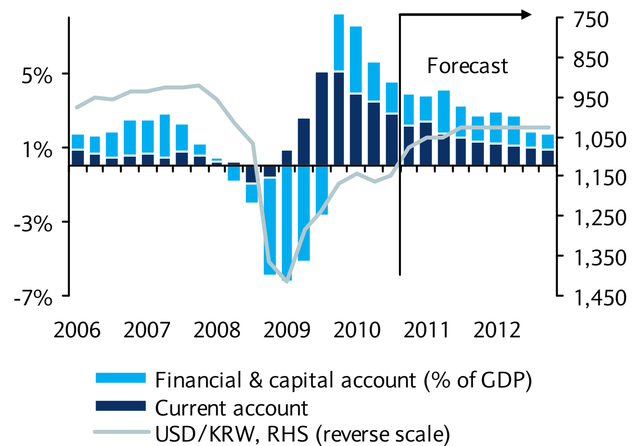
Reserve accumulation should give way to further currency strength. Given that the KRW REER is still well below its trend average, there is room for appreciation. This should reduce the urgency to accumulate reserves. Some USD23.4bn has been added to reserves this year, bringing the total to USD293.4bn at end-October. The marginal benefit of accumulating additional reserves is falling, especially as they already cover than 2x outstanding short-term external debt (1.5x a year ago).

Figure 1: Higher costs in China will feed into Korea's CPI



Source: CEIC, Barclays Capital

Figure 2: Room for KRW to lean against imported inflation



Source: CEIC, Barclays Capital

Industrial momentum cooling, utilisation rates subsiding

High frequency activity indicators are slowing. Factory utilisation slid to 79.5% in October from 81.5% in September, and is well off the peak of 84.8% in July, led by slower global demand for electronics, particularly memory chips. As at the end of November, benchmark DRAM (1GB, DDR2, 128Mb) prices have fallen 53% from the peak in March and 28% since 1 September, reflecting concerns about an oversupply early in 2011. This set the stage for the inventory/shipment ratio to climb to 1.03 in October, up from 1.00 in August, the highest print since May 2009 and above its five-year average of 1.01. This signals that IP momentum could slow further in coming months, despite stronger activity in the vessel and auto sectors, which has mitigated the slowing in the electronics sector.

Food inflation to subside quickly, core inflation remains well behaved

Temporary factors such as a surge in food prices have caused some inflation concerns. But inflation receded sharply in November, falling to 3.3% y/y from 4.1% in October. The drop reflects the effects of administrative measures, namely, increased price surveillance, lowered agricultural tariffs and the release of stockpiled vegetable supplies. As a result, food's contribution to the headline rate fell to 190bp from 238bp in October. For instance, the price for one head of Napa cabbage grown in Korea (an ingredient of kimchi) rose to USD14 in October from USD2.50 in September but fell to USD3 by mid-November. At the same time, the BoK's index of expected inflation six months ahead, which eased to 141 in November from 146 in August, could see further downside as suspension of the 5.2% gas tariff hike is felt. This could ease concerns about core inflation, which slowed to 0.18% in November, similar to the pace in October, but below the April-September average of 0.25%.

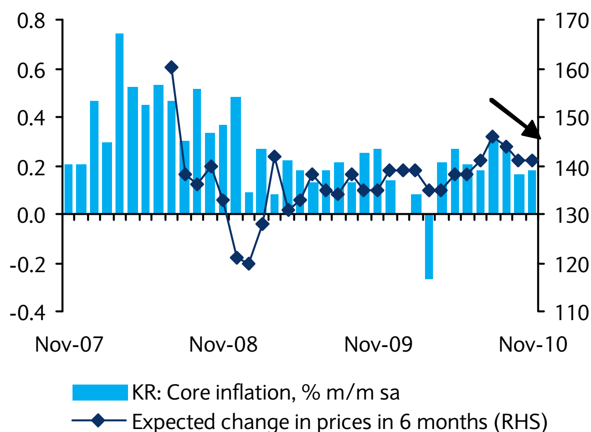
The BoK is likely to take a gradualist approach - we look for a 75bp increase in the policy rate in 2011

Taken together, the Bank of Korea faces a difficult balancing act – weighing the risks of external uncertainties against a strong domestic economy that has started to cool. Coupled with a slowing in high-frequency activity indicators, we believe the BoK is likely to maintain a gradual approach to normalising rates – lifting the policy rate 75bp, to 3.25%, by end-2011. At the earliest, we expect the next rate hike at end-Q1 11, when the global electronics cycle is expected to re-accelerate. Against this backdrop, we are comfortable with our growth forecast of 4% in 2011, following the estimated 6.1% expansion in 2010.

We recommend hedging against geopolitical tail risk events

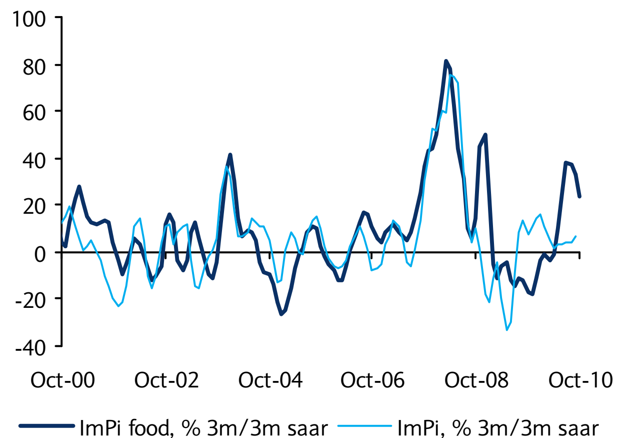
Geopolitical risk has become more important when evaluating Korean assets. As a short position in Korea CDS could provide a tail risk hedge, we recommend buying 5y CDS on Korea sovereign and selling 5y CDS on the Malaysia sovereign. Given that Korea CDS spreads have widened after the recent shelling, we recommend building the position slowly and would be comfortable with putting on the trade in full size only if the spread narrowed to less than 20bp.

Figure 3: Core and inflation expectations subsiding



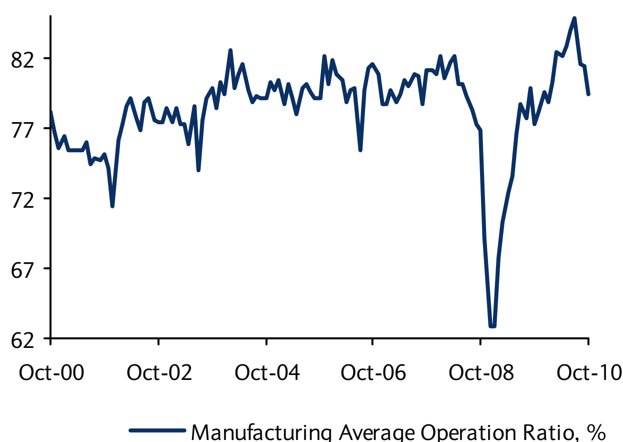
Source: CEIC, Barclays Capital

Figure 4: Imported food price pressures easing



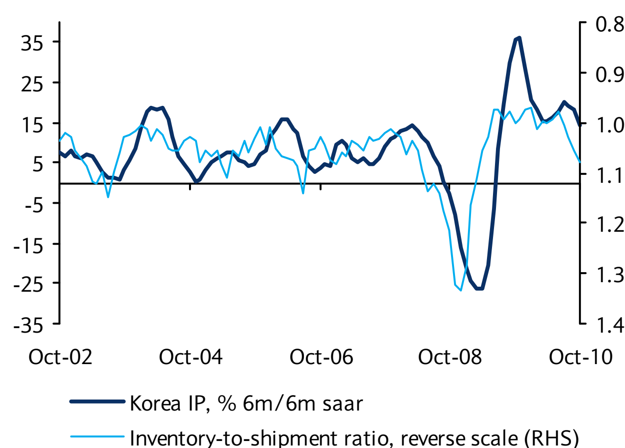
Source: CEIC, Barclays Capital

Figure 5: Capacity utilisation eased from its10-year high



Source: CEIC, Barclays Capital

Figure 6: Rise in I/S ratio signals slower IP momentum



Source: CEIC, Barclays Capital

Figure 7: Korea macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	5.1	2.3	0.2	6.1	4.0	4.5
Domestic demand contribution (pp)	4.4	1.4	-3.0	6.2	3.0	2.6
Private consumption (% y/y)	5.1	1.3	0.2	4.1	2.9	3.2
Fixed capital investment (% y/y)	4.2	-1.9	-0.2	6.4	2.4	2.8
Net exports contribution (pp)	0.7	1.1	3.1	0.1	0.9	1.9
Exports (% y/y)	12.6	6.6	-0.8	11.8	5.6	8.0
Imports (% y/y)	11.7	4.4	-8.2	13.8	4.4	4.9
GDP (USD bn)	1050	948	842	1010	1186	1279
External sector						
Current account (USD bn)	5.9	-5.8	42.7	32.0	20.1	15.0
CA (% GDP)	0.6	-0.6	5.1	3.2	1.7	1.2
Trade balance (USD bn)	28.2	5.7	56.1	51.1	28.5	23
Net FDI (USD bn)	-13.8	-15.6	-9.1	-19.1	-4.0	-4.0
Other net inflows (USD bn)	23.4	-34.6	34.3	23.0	21.4	12.9
Gross external debt (USD bn)	383.2	377.9	401.9	415.0	410.0	405.0
International reserves (USD bn)	262.2	201.2	270.0	302.0	330.0	345.0
Public sector						
Public sector balance (% GDP)	3.5	1.2	-1.7	-0.2	0.2	0.2
Excluding social security funds (% GDP)	0.4	-1.5	-4.1	-2.7	-2.0	-1.8
Gross public debt (% GDP)	29.7	29.0	32.6	33.0	32.0	30.0
Prices						
CPI (% Dec/Dec)	3.6	4.1	2.8	3.9	1.9	1.4
FX, eop	921	1,363	1,167	1,100	1,025	1,025
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	6.1	4.5	4.8	3.8	3.7	4.0
CPI (% y/y, eop)	2.4	2.9	4.0	3.5	2.9	2.4
FX (domestic currency/USD, eop)	1,158	1,130	1,100	1,075	1,050	1,025
Base rate (%, eop)	2.00	2.50	2.50	2.75	3.00	3.25
Market implied rate (%, eop)	2.41	2.8	2.80	2.95	3.10	3.3

Source: Barclays Capital

EMERGING ASIA: MALAYSIA

Taking the fast track

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Stronger growth, and rising commodity prices and investment income should cut the fiscal deficit significantly. As many as six companies could be privatised in H1 11, which could generate positive wealth effects that would pave the way for elections in 2012. We remain bullish on the MYR and prefer to buy long-end MGS, currency unhedged.

Political willingness to implement reforms is rising

We believe political and economic dynamics have started to improve in Malaysia. More specifically, we believe the current administration has enough political support to follow through with the implementation of its reform agenda. This is likely to go a long way toward dispelling the perception among some investors that the administration cannot deliver. It should also finally reverse the country's poor image among international investors who remember the implementation of capital controls in 1998.

Shifting gears - focus turns to politics

The administration would like to deliver visible results before calling elections

With the key economic initiatives – the Economic Transformation Programme, the 10th Malaysia Plan and the New Economic Model 2 – now released, we expect the focus to turn to the political agenda (the next general election is due by 2013). Some political analysts believe the PM may call elections in 2011. This is a possibility, but we think the administration will want to get more momentum behind its reforms and deliver visible signs of change before going to the polls. Over the next 6-12 months, we believe PM Najib will be in a position to provide concrete signs of transformation, especially in urban areas. More specifically, the government plans to upgrade urban infrastructure, step up education spending, begin the "greening" Kuala Lumpur and improve the efficiency of the civil service.

Figure 1: The Malaysian government remains committed to structural transformation

Date	Event	Comments	Positive for
Key milestones and policy announcements so far			
23 Sep 10	Upgraded by FTSE to advanced emerging market status	Malaysia's weight in FTSE will increase from 1.4% to 2.4% in June 2011 when the upgrade takes effect.	Equities, FX
15 Oct 10	Annual Budget for 2011	More focus on long-term projects and urban infrastructure.	MGS, equities, FX
25 Oct 10	Economic transformation programme launched	An economic blueprint consisting of specific projects and timelines for projects under the New Economic Model.	Equities, FX
23 Nov 10	Second IPO - Petronas Chemicals	The largest IPO in Malaysian history, raising nearly USD4.2bn.	Equities, FX
29 Nov 10	Petronas announces record dividend to government	Petronas will pay a USD9.5bn dividend to government in March 2011 – upside for estimated fiscal deficit (5.4% of GDP).	MGS, FX
Events likely to generate positive news flow over the next six months			
Jan 11	Phased removal of petrol subsidies	Ongoing reduction of subsidies by increasing prices of Ron 95 gasoline (MYR1.85/litre), Ron 97 (MYR2.15) and diesel (MYR1.75).	MGS, FX
Jan 11	Singapore-Kuala Lumpur high-speed rail link (HSDR)	Final details on the HSDR to be tabled for Cabinet approval in early January 2011.	Equities, FX
Q1 11	More IPOs to be announced	We think the government could announce 5-6 IPOs in the next 3-6 months.	MGS, Equities, FX
H1 11	New Economic Model - part 2	The second part of the New Economic Model is likely to focus on "1 Malaysia" and social issues.	MGS, FX
Long-term policy objectives likely to be tackled with a stronger political mandate			
Post-elections	30% local rules for FDI investors in strategic industries.	Further dilution of the 30% Bumiputera shareholding requirement guideline imposed on FDI investors.	MGS, Equities, FX
Post-elections	Implementation of GST	Likely to start with 4% with incremental target of 10%.	MGS, FX
Post-elections	Normalisation of electricity tariffs	Removal of subsidised natural gas to electricity companies.	MGS, Equities, FX

Source: Factiva, Bloomberg, PEMANDU, PMO, Barclays Capital

The stage is set for stronger growth in tax revenue. With palm oil prices expected to increase further and unemployment back at pre-crisis levels, we estimate that growth in tax revenue can be sustained above 12%. We believe the official tax collection forecasts are conservative, especially relative to the pace of nominal GDP growth we expect in 2011. Another factor of support is the multi-year privatisation programme and large dividend payments. On 30 November, Petronas announced it will maintain its dividend payment of MYR30bn to the government for 2010, and we believe it is likely to remain unchanged in 2011.

Figure 2: With relatively stronger tax collections, fiscal deficit could easily fall below 4% in 2011

Fiscal balance (% of GDP)		Total expenditure growth (% y/y)			
		0.0	**3.0**	**5.0**	**8.0**
Tax revenue growth (% y/y)	**8.0**	-3.7	-4.4	-4.9	-5.6
	10.0	-3.5	-4.2	-4.7	-5.4
	12.0	-3.2	-3.9 (base case)	-4.4	-5.1
	14.0	-3.0 (optimistic)	-3.7	-4.2	-4.9
	16.0	-2.7	-3.4	-3.9	-4.6

Source: Ministry of finance, CEIC, Bloomberg, Barclays Capital

Strong position to cut the fiscal deficit significantly

All this suggests the government is in a strong position to cut the deficit significantly. In Figure 2, we show the sensitivity of the fiscal deficit to tax revenue growth – ranging from 8% to 16%. This range is consistent with the pace of revenue growth in the past five years of around 12%. Interestingly, the tax assessment year change in 2008 to the present year has significantly shortened the lag between economic growth and tax collections (see Figure 5).

We maintain our view that market estimates of the borrowing requirement are overstated

Our base case for net issuance in 2011 is MYR32.1bn, which combined with MYR45bn in redemptions, implies a gross issuance of MYR77.1bn. It is possible that a further modest rise in tax collections could reduce net issuance further. However, as we demonstrate in Figure 3 (column on the far right), actual net issuance could surprise on the downside. We remain positive on the MGS market as a result. A supporting driver is Bank Negara Malaysia becoming slightly more concerned about inflation in 2011. We now expect the BNM to hike rates 50bp in H1 11, as it normalises policy further.

The recent pick-up in commodity prices to provide another factor of support for MYR appreciation

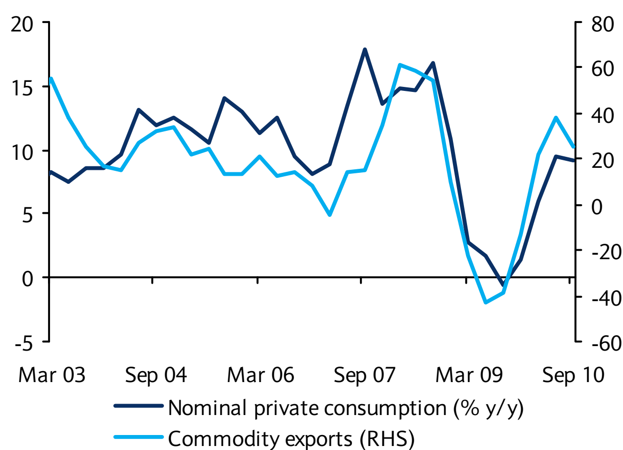
We continue to recommend buying long-end MGS, currency unhedged. The recent surge in global commodity prices is likely to provide a big boost to Malaysia's external position. Commodities account for over 25% of exports, and along with consistent portfolio inflows, we believe the potential for MYR appreciation remains intact. We continue to expect the MYR to appreciate to 2.92/USD in 12 months.

Figure 3: Fiscal position likely to improve considerably in 2011

	2010 (official)	2010 (BarCap)	2011 (Official)	2011 (BarCap)
Total revenue (MYR bn)	162.1	167.6	165.8	178.5
Tax revenue	107.1	107.6	115.5	120.5
Investment income and others	55.0	60.0	50.3	60.0
Total Expenditure (MYR bn)	206.2	206.2	212.0	212.3
Fiscal deficit (MYR bn)	-44.1	-38.6	-46.2	-33.8
Fiscal deficit (% of GDP)	-5.6	-5.0	-5.4	-3.9
Gross borrowing (MYR bn)	65.6		84.3	77.1
Bond redemptions (MYR bn)	28.5		45	45
Net borrowing (MYR bn)	37.1		39.2	32.1

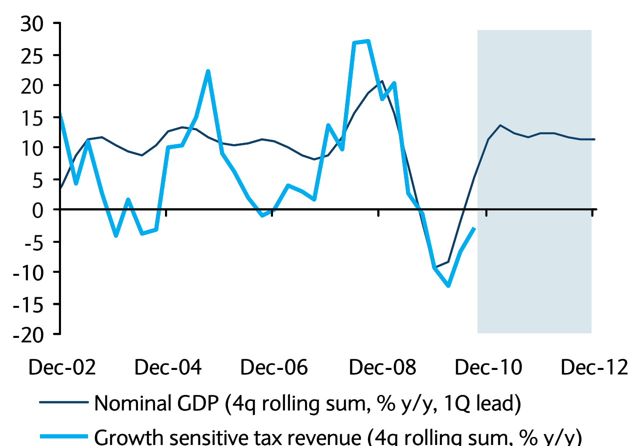
Source: Ministry of Finance, Barclays Capital

Figure 4: Higher commodity prices should benefit growth



Source: CEIC, Barclays Capital

Figure 5: The pro-cyclicality of tax collections has improved



Source: CEIC, Barclays Capital

Figure 6: Malaysia macroeconomic forecast

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.5	4.7	-1.7	7.5	5.5	6.0
Domestic demand contribution (pp)	7.9	5.1	-2.3	10.1	3.3	4.7
Private consumption (% y/y)	10.5	8.5	0.7	6.6	6.5	5.8
Fixed capital investment (% y/y)	9.4	0.7	-5.6	9.3	6.2	4.1
Net exports contribution (pp)	-1.4	-0.4	0.6	-2.6	2.2	1.3
Exports (% y/y)	4.1	1.6	-10.4	10.0	6.9	9.5
Imports (% y/y)	5.9	2.2	-12.3	14.2	5.4	9.3
GDP (USD bn)	187.2	222.8	193.7	240.2	282	333
External sector						
Current account (USD bn)	29.9	38.9	31.7	25.2	38.5	33.0
CA (% GDP)	16.0	17.4	16.4	10.5	13.7	9.9
Trade balance (USD bn)	37.8	51.2	40.3	42.5	57.9	45.0
Net FDI (USD bn)	-2.8	-7.8	-6.6	1.8	4.5	4.0
Other net inflows (USD bn)	-8.7	-25.9	-16.0	-11.9	-18.0	-12.0
Gross external debt (USD bn)	55.8	66.4	68.6	74.2	77.0	80.0
International reserves (USD bn)	119.5	92.1	97.6	110.0	125.0	140.0
Public sector						
Public sector balance (% GDP)	-3.2	-4.8	-7.1	-5.0	-3.9	-2.8
Gross public debt (% GDP)	41.5	41.4	53.3	50.8	48.4	47.2
Prices						
CPI (% Dec/Dec)	2.39	4.39	1.07	2.04	2.22	2.43
FX, eop	3.31	3.46	3.42	3.05	2.92	2.90
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	4.40	5.33	6.09	5.00	4.34	5.82
CPI (% y/y, eop)	2.04	1.78	2.04	2.67	2.63	2.46
FX (domestic currency/USD, eop)	3.40	3.10	3.05	3.03	2.99	2.95
Overnight policy rate (%, eop)	2.00	2.75	2.75	3.00	3.25	3.25

Source: Barclays Capital

EMERGING ASIA: PHILIPPINES

We remain positive on Philippines assets

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The policy signals from the Aquino administration are positive, and we expect the Philippines to be upgraded by Moody's to Ba2. We expect USD/PHP to hit 40 by end-2011, given robust remittances and rising BPO-related revenues.

S&P upgraded the Philippines to BB; we expect Moody's to play catch-up

On 12 November, S&P raised the Philippines' long-term foreign currency rating to BB from BB- while maintaining its Stable Outlook, given the country's improving external liquidity profile. We expect Moody's to play catch-up and upgrade the sovereign to Ba2 in the coming months given the resiliency of the balance of payments, some progress towards fiscal consolidation and the government's attempt to address infrastructure issues through private-public partnerships.

Fiscal consolidation to be in focus

We expect the budget deficit to improve to 3.2% of GDP in 2011

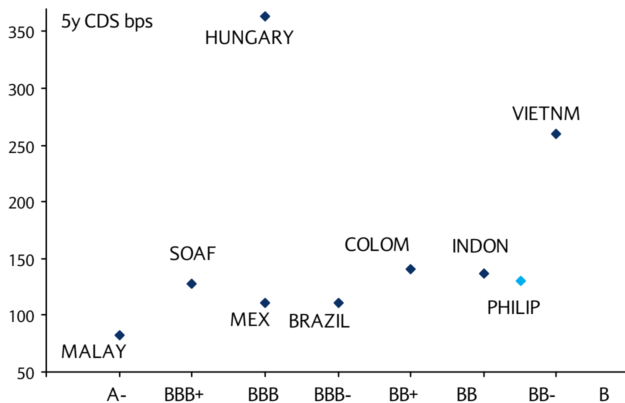
The Aquino administration remains focused on fiscal consolidation and improved debt liability management for the sovereign. Given the better-than-expected fiscal performance since August, we believe the government may undershoot its annual budget deficit target of PHP325bn. We expect the budget deficit to come in at 3.4% of GDP (PHP290bn) in 2010 and to improve to 3.2% of GDP in 2011 (PHP300bn, versus government forecast of PHP290bn). In terms of financing, three-fourths will be from domestic sources (PHP563bn), supported by flush domestic liquidity. The government's planned foreign borrowing is USD4.5bn, including USD2.5bn of commercial borrowing. We believe the latter includes USD1bn worth of global peso bonds, with the sovereign having a bias to issue longer-dated maturities.

Robust external position…

… is supported by remittances, BPO and rising FDI

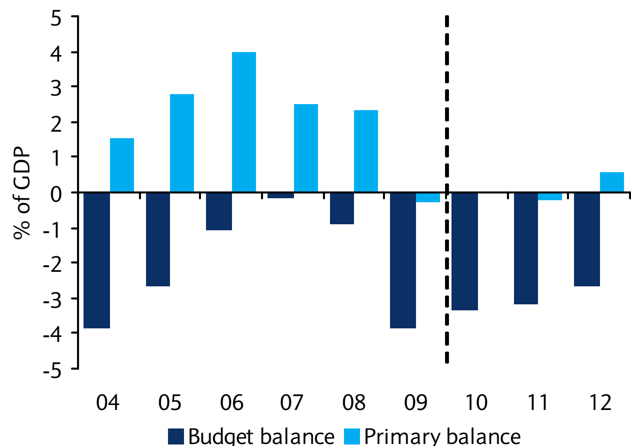
The Philippines' external position remains robust, with remittances of nearly USD14bn in January-September, on track to achieve our USD 17.5bn projection. With exports holding up better than our expectations despite the collapse in DRAM chip prices, we are raising our 2010 current account forecast to USD10.7bn from USD9bn. We expect the surplus to widen to USD14.6bn (6.5% of GDP) in 2011, supported by USD19bn of remittances and rising business process outsourcing-related revenues. Although we expect the trade deficit to deteriorate to USD6bn in 2011, the high import content of exports limits overall weakening in the face of slowing shipments. On the capital account side, we expect FDI to rise gradually and portfolio flows to increase, given favourable interest rate and growth differentials. Despite the recent run-up, the Philippines stock market remains attractive on a valuation basis (P/E ratio 13.7).

Figure 1: Philippines compares favourably vs other sovereigns



Source: Bloomberg, Barclays Capital

Figure 2: Fiscal position to improve gradually



Source: CEIC, Barclays Capital

The PHP has underperformed given increased intervention the spot market…

Despite the country's strong BoP position the PHP has been the second-worst performer in the region since early November. In our opinion, one of the key reasons for its underperformance has been increased intervention in the spot market by the central bank, given its discomfort with the rapid pace of appreciation over a short period of time. At the same time, Bangko Sentral ng Pilipinas has raised concerns about the growth of the NDF market, which has been affecting the onshore spot and swap markets. Based on meetings with policymakers, our sense is that BSP is not targeting a specific level for the PHP – its focus remains managing volatility. There has been no structural shift in the central bank's intervention policy, and we believe BSP will use forwards again when it feels that strategy is appropriate. However, it is worth highlighting that the central bank remains wary of appreciation driven by "hot money" rather than real flows. Although we remain bullish on the PHP given the likely external funding surplus in 2011, the country's strong growth and its positive ratings trends, we now expect USD/PHP to drift to 40 by year-end 2011 rather than Q3 previously.

… policy focus remains PHP volatility – not its level…

… supportive fundamentals mean trend appreciation to continue

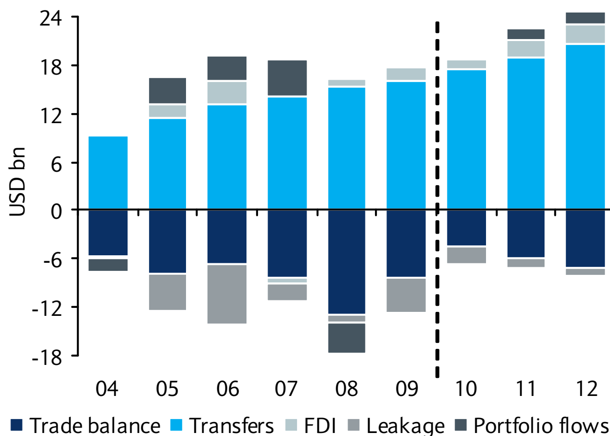
Inflation to remain relatively benign…

Inflation has surprised on the downside in 8 out of 11 months this year, and was a benign 3.0% y/y in November. We expect inflation to average 3.9% in 2010, towards the lower end of the BSP's 3.5-5.5% target. Into 2011, food prices are expected to rise, especially given the increase in international food commodity prices, with rice prices being key. However, we believe fuel-related costs will continue to serve as a dampening factor, given our in-house forecast that oil will average USD85/bbl in 2011. In addition, core prices are expected to remain relatively contained, with the output gap closing only in Q1 11. Overall, we expect inflation to average 3.6% in 2011 (BSP's forecast is 2.4%), towards the lower end of the central bank's target of 3-5%.

…suggesting a gradual and cautious approach to policy normalisation

Given the relatively benign inflation trajectory, as well as BSP's concern that rising interest rate differentials could complicate monetary policy, we believe that the central bank will be cautious in policy normalisation. As such, we are pencilling in the first rate hike in Q3 11, with inflation and external developments the key factors to watch. The main risk to our forecast would be a commodity price shock, especially in food and oil. The central bank has also highlighted strong foreign inflows and loose policy measures in advanced economies as potential upside risks to inflation.

Figure 3: Robust BoP position driven by remittances



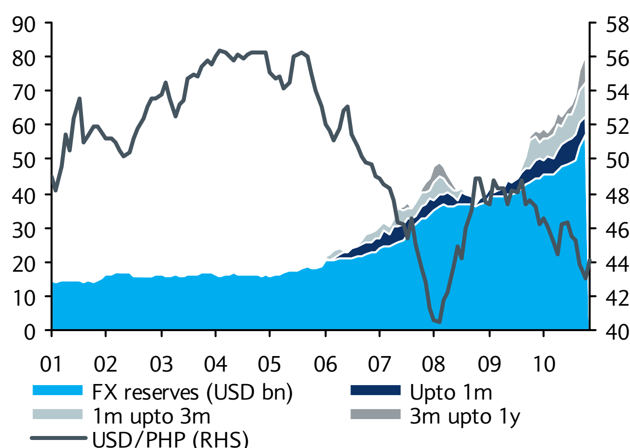
Note: Leakages = other investments + errors and omissions.
Source: CEIC, Barclays Capital

Figure 4: Philippines to enjoy a funding surplus in 2011

(USD bn)	2010	2011
1) Principal repayment on medium to long-term debt	4.8	4.5
2) Short term debt	9.2	9.0
3) Principal repayments and short-term debt (1+2)	14.0	13.5
4) Current account	10.8	14.6
5) FDI	1.1	3.5
6) Portfolio	1.2	2.0
7) Total available funding (5+6)	-0.1	1.5
8) Funding gap (3-(4+7))	2.1	-4.6
9) FX reserves	57.0	73.8
10) Funding gap as a % of FX reserves	3.8	-6.2

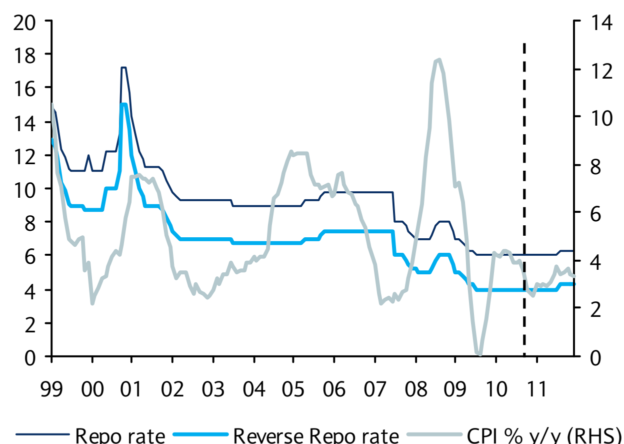
Note: Negative funding gap denotes a surplus.
Source: IIF, World Bank, Barclays Capital

Figure 5: Large FX reserve position



Source: CEIC, Barclays Capital

Figure 6: Gradual and cautious policy normalisation



Source: CEIC, Barclays Capital

Figure 7: Philippines macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	7.1	3.7	1.1	7.0	5.0	5.6
Domestic demand contribution (pp)	7.2	4.1	2.8	6.6	5.8	5.7
Private consumption (% y/y)	5.8	4.7	4.1	4.8	5.2	5.4
Fixed capital investment (% y/y)	10.9	2.7	-0.4	16.1	7.8	7.0
Net exports contribution (pp)	4.9	-1.3	-5.4	2.3	0.0	-0.2
Exports (% y/y)	5.5	-2.0	-13.4	23.3	4.5	4.8
Imports (% y/y)	-4.1	0.8	-1.9	16.4	4.5	5.0
GDP (USD bn)	145	166	161	189	222	259
External sector						
Current account (USD bn)	7.1	3.6	8.8	10.8	14.6	15.4
CA (% GDP)	4.9	2.2	5.4	5.7	6.6	5.9
Trade balance (USD bn)	-8.4	-12.9	-8.3	-4.4	-5.9	-7.3
Net FDI (USD bn)	-0.6	1.3	1.6	1.2	2.0	2.5
Other net inflows (USD bn)	4.1	-3.0	-2.8	-0.4	1.5	2.3
Gross external debt (USD bn)	55.1	54.0	54.6	57.5	58.8	60.8
International reserves (USD bn)	33.7	36.0	44.2	57.0	73.8	92.8
Public sector						
Public sector balance (% GDP)	-0.2	-0.9	-3.9	-3.4	-3.2	-2.7
Primary balance (% GDP)	2.5	2.3	-0.3	0.0	-0.2	0.5
Gross public debt (% GDP)	71.8	76.9	68.6	67.1	63.1	59.8
Prices						
CPI (% Dec/Dec)	3.9	8.0	4.3	3.0	3.3	3.5
FX, eop	41.4	47.5	46.4	43.5	40.0	38.0
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	2.1	6.5	5.8	4.0	4.5	5.8
CPI (% y/y, eop)	4.3	3.5	3.0	3.4	3.8	3.9
FX (domestic currency/USD, eop)	46.4	43.9	43.5	42.0	41.5	41.0
Overnight policy rate (%, eop)	4.00	4.00	4.00	4.00	4.00	4.25

Source: Barclays Capital

EMERGING ASIA: SINGAPORE

Resurgence of inflation risks

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With full employment, the focus of policy has tilted towards inflation – a situation we expect to prevail through to the next policy meeting in April 2011. The emergence of demand-pull pressures could be a pre-cursor for additional monetary tightening, likely a steepening of the SGD NEER slope. We expect the SGD to reach 1.26/USD in 12m.

Overheating pressures are starting to show up in the labour markets

Wage pressures are emerging. The participation rate of the resident workforce reached a record 66.2% this year (65.4% a year ago), as unemployment receded to a post-Lehman trough of 2.1%. As a result, pay packets are rising faster. For instance, the median monthly income rose 4.2% this year, and we estimate (using data from the tax authorities) that the number of residents with incomes above SGD100,000 has doubled in the last five years to 300,000. With the continued addition of new capacity in the manufacturing, retail and financial services sectors, we expect wage pressures to persist well into 2011.

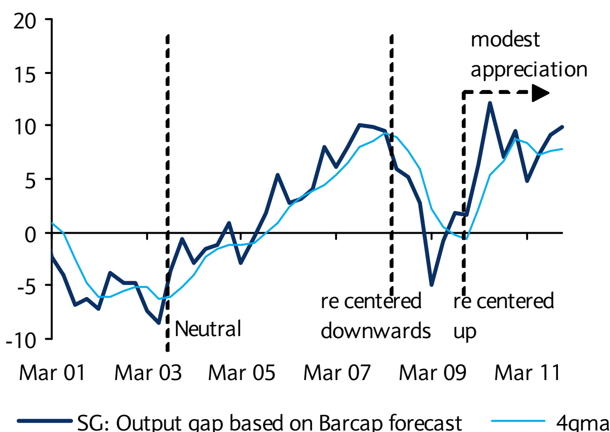
The feel-good factor is in full force, promoting discretionary spending

Accentuating this is a cycle of strong wealth creation, which has been fuelled by a surge in inward migration and rising asset values. The Monetary Authority of Singapore's (MAS) Financial Stability Report also showed that net wealth of households has risen by 29% from the trough in 1Q 09. This has fuelled a boom in discretionary spending and added resilience to the property market. For instance, private home prices rose by 2.9% in Q3, marking five successive quarters of increases. From the trough in Q2 09, home prices have now risen by more than 42%, a clear sign that a further tightening of prudential curbs may be warranted, as affordability in the suburban areas continues to worsen.

Signs of demand-pull are emerging – services inflation creeping up

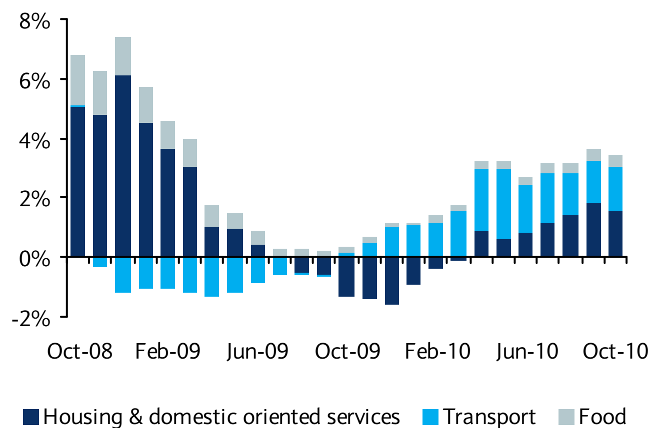
A clear sign of wage pressure is the increase in services costs. The costs of accommodation and domestic-oriented services such as healthcare, recreation and education accounted for more than half of CPI inflation in October – which has been rising steadily since May. This reflects both resurgent wage pressures in the economy as well as the pass-through of higher energy costs in the services sector. Taken together, we are forecasting headline CPI inflation of around 4% by the end of 2010 and for it to remain high in the first half of 2011 before moderating. On an average basis, we expect headline inflation to ease only slightly to 2.6% in 2011, after averaging 2.8% in 2010.

Figure 1: Greater willingness to tolerate a stronger currency



Source: CEIC, Barclays Capital

Figure 2: Signs of demand-pull – rise in services inflation



Source: CEIC, Barclays Capital

A key driver to date has been higher imported prices – both from a near-term spike in soft commodity prices but increasingly also from rising labour costs in China. Even after tightening monetary policy more aggressively, MAS expects underlying inflation, which excludes the cost of accommodation and private road transport, to average 2-3% in 2011, above the 2% in 2010. Among the eight main CPI components, October saw m/m increases in seven of them, with only communications falling (by 0.9% m/m nsa).

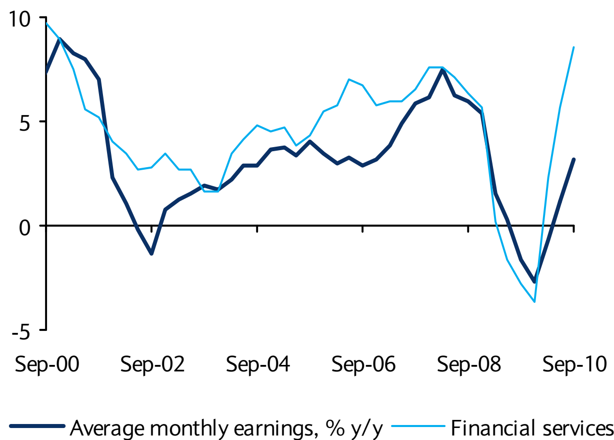
Business and living costs are also on the rise

Wages aside, business costs, led by record CBD office rents and utilities charges, will likely be a more visible theme next year. The government's policy challenge will increasingly be to manage supply bottlenecks and contain overheating pressures while keeping a close watch on concerns about the global economy. Meanwhile, demand is burgeoning for prime office and industrial space in Singapore. According to CB Richard Ellis, driven by strong demand Singapore office rents rose 7.2% in Q3 to SGD7.40 per square foot per month, the highest since 2008. This rise in office rents has exceeded the 3.2% average for Asia, though lagged the 10.8% jump in Hong Kong. According to Jones Lang LaSalle, Singapore is ranked fourth out of 26 Asia-Pacific cities in terms of office rent levels. It has also become a more expensive for expatriates, climbing from the ninth most expensive location in Asia to eighth, according to a poll by ECA International. Higher living costs are likely to lead to more generous wage settlements, which could in turn fuel demand-pull pressures.

Inflation risks overshadow concerns of a slowing electronics cycle

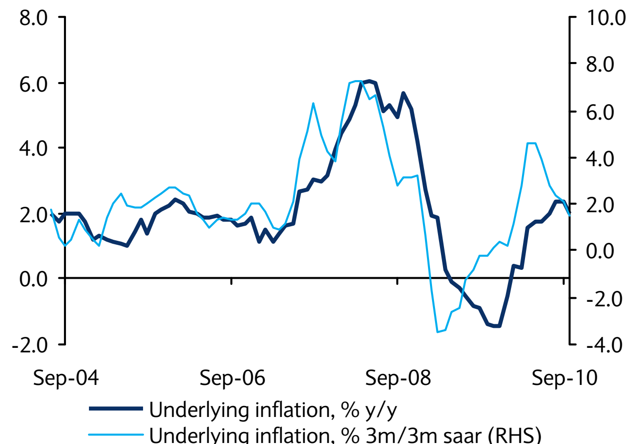
For now, inflation risks have overshadowed concerns that the electronics cycle is slowing. Although industrial output expanded 31% y/y in October, the upside surprise was driven by the continuing strength in pharmaceuticals production. On a trend basis, momentum in the wider manufacturing sector continued to slow. Excluding pharmaceuticals, IP fell 1.9% m/m on a seasonally adjusted basis in October. We look for further price softness and a pause in replacement demand for PCs and electronic components in Q4 10, ahead of the scheduled launch of Intel's revolutionary "Sandy Bridge" chipsets in Q1 11. However, PC makers expect to begin shipping notebooks with the new Intel (Sandy Bridge) platforms in December and launch new PC products in Q1 2011. This should propel demand for components such as integrated circuits that are made in Singapore. This could assuage concerns over growth – especially when officials are confident that the economy can grow by a further 4% in 2011, after the record 15% expansion expected for 2010.

Figure 3: Wage pressures likely to persist into 2011



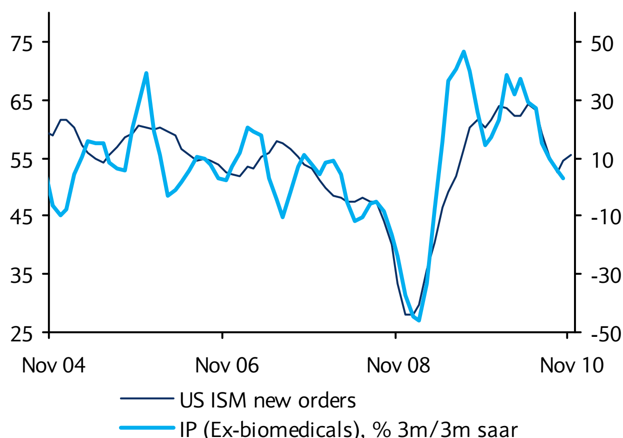
Source: URA, CEIC, Barclays Capital

Figure 4: Underlying inflation momentum creeps up



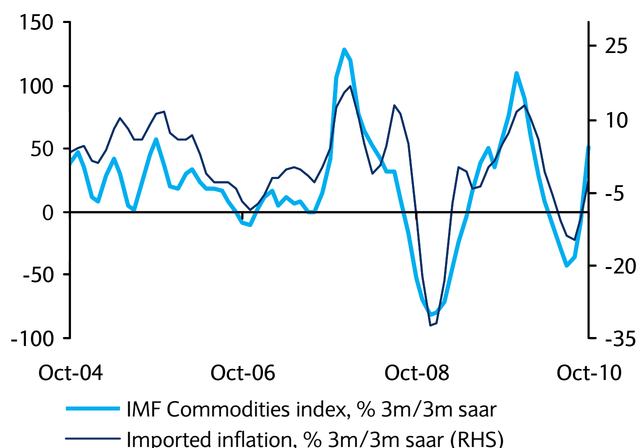
Source: URA, CEIC, Barclays Capital

Figure 5: Industrial momentum starting to ease



Source: CEIC, Barclays Capital

Figure 6: Spike in commodity prices could be short lived



Source: CEIC, Barclays Capital

Figure 7: Singapore macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	8.5	1.8	-1.3	15.0	4.0	6.5
Domestic demand contribution (pp)	5.4	10.2	-3.8	5.7	2.4	2.1
Private consumption (% y/y)	6.5	2.7	0.4	5.6	2.9	3.1
Fixed capital investment (% y/y)	19.9	13.6	-3.3	5.4	3.0	3.6
Net exports contribution (pp)	4.7	-9.0	2.3	9.2	1.1	4.3
Exports (% y/y)	8.9	4.1	-9.0	20.1	4.9	4.2
Imports (% y/y)	7.8	9.2	-11.0	18.0	5.1	2.7
GDP (USD bn)	177	194	183	227	258	283
External sector						
Current account (USD bn)	47.2	35.8	32.4	44.6	41.6	37.0
CA (% GDP)	26.6	18.5	17.7	19.7	16.2	13.1
Trade balance (USD bn)	46.1	26.4	30.0	47.0	44.7	39.7
Net FDI (USD bn)	8.1	19.4	10.8	23.4	20.8	16.7
Other net inflows (USD bn)	-39.5	-43.4	-31.1	-24.5	-30.2	-27.8
Gross external debt (USD bn)	55.8	66.0	70.3	77.4	82.0	86.0
International reserves (USD bn)	163.0	174.2	187.8	225.0	245.0	260.0
Public sector						
Public sector balance (% GDP)	3.1	0.1	-1.2	0.2	0.0	0.5
Primary Balance (% GDP)	2.5	-0.2	-1.5	-0.5	-0.3	0.2
Gross public debt (% GDP)	96.3	92.0	117.0	98.1	95.0	95.0
Prices						
CPI (% Dec/Dec)	3.7	5.5	-0.5	4.2	1.8	2.3
FX, eop	1.45	1.48	1.40	1.30	1.26	1.26
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	3.8	10.5	13.2	4.1	-0.2	6.9
CPI (% y/y, eop)	-0.8	3.4	3.8	3.7	2.9	2.0
FX (domestic currency/USD, eop)	1.40	1.33	1.30	1.29	1.28	1.27

Source: Barclays Capital

EMERGING ASIA: SRI LANKA

Making progress

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We expect Sri Lanka to be upgraded to BB- in 2011 as the country's budget and external position continue to improve. The growth outlook remains robust, with remittances continuing to support the balance of payments position. Given rising inflationary pressures, we expect the central bank to begin hiking rates in Q2 2011.

We expect one notch upgrade to BB- in 2011

We remain constructive on the Sri Lankan sovereign given its gradually improving budget position, upbeat growth outlook, robust balance of payments and rising FX reserves. Sri Lanka foreign currency debt is rated at B+ by the three major rating agencies and we continue to expect a one notch upgrade to BB- in 2011.

We expect the budget deficit to improve to 7% of GDP in 2011 from 8.5% in 2010…

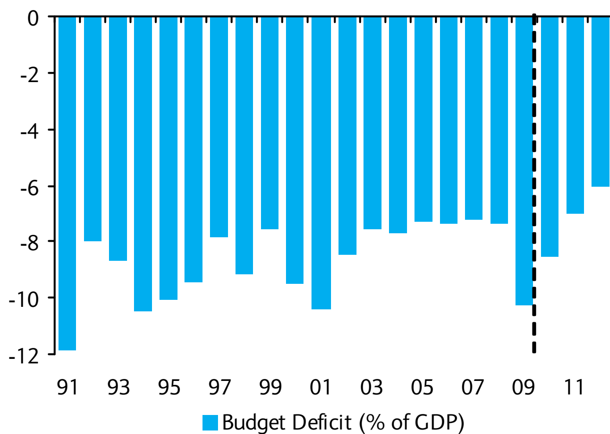
… 2011 budget broadly in line with IMF suggestions, but more needs to be done

The Sri Lankan government announced the 2011 budget at the end of November, targeting a fiscal deficit of 6.8% of GDP, down from a target of 8% in 2010. Given that the deficit in the first eight months of the year totalled LKR315bn, or 70.5% of the full-year target of LKR446.7bn, we expect 2010 budget deficit to come in at 8.5% of GDP. The 2011 budget was broadly consistent with the spirit of IMF suggestions, with the government undertaking some revenue-generating measures such as an 8% increase in electricity tariffs from January, a licence fee for telecom services and an upward revision in motor vehicle registration fees. At the same time, it showed restraint in adjusting public sector salaries and pensions. However, the government cut the income tax rate and reduced tax rates for all export and tourism industries by 3pp, to 12%, and for the financial sector by 7pp, to 28%. To move towards the IMF's budget deficit target of 5% of GDP by 2010 we believe more needs to be done. We think it is also worth highlighting that the bulk of 2011 financing is expected to come from domestic sources (78% vs 54% in 2010), suggesting a bias to reduce government offshore commercial borrowing, which is positive for the credit.

GDP growth forecast at 7.5% in 2010 and 6.8% in 2011

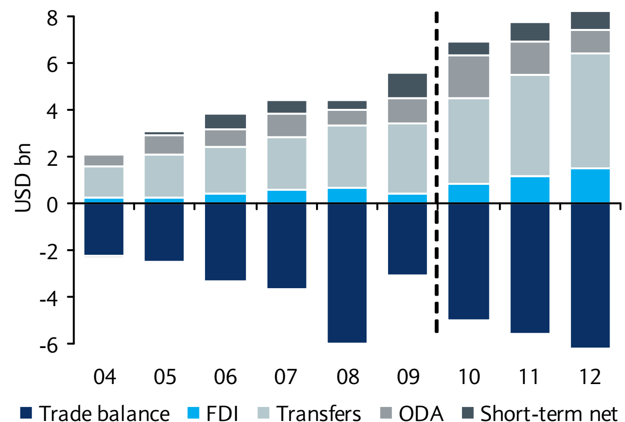
We remain comfortable with our 2010 GDP forecast of 7.5%, given increased activity in the north and east, strong tourist arrivals and upbeat business sentiment. Credit growth has also accelerated, in line with activity, with the 3m/3m saar of private sector loans running at 27.5% versus 3.6% in January. Growth is expected to slow in 2011, to 6.8%, given a moderation in global demand and the dampening impact of high inflation.

Figure 1: Gradually improving budget deficit



Source: CEIC, Barclays Capital

Figure 2: Robust balance of payments position



Source: CEIC, Barclays Capital

BoP to remain in surplus supported by remittances…

… allowing further buildup of FX reserves

Foreign exchange reserves continue to hit historical highs – reaching USD6.7bn at the end of October, supported by the USD1bn sovereign issuance in September. FX reserves are equivalent to import cover of 6.3 months and compare with short-term external debt of USD1.5bn as of Q2 10, according to World Bank data. Sri Lanka's balance of payments position also remains robust on the back of remittances, despite a worsening in the trade deficit, owing to higher food commodity prices. Remittances were USD2.8bn in the first nine months, and remain on track to meet our forecast of USD3.6bn for 2010. For 2011, we are projecting remittances of USD4.2bn. Services revenues also continue to rise given healthy tourist arrivals and increased transhipment activity. On the capital account, we expect FDI to rise gradually given expected strong growth and past underinvestment. Overall, we expect the BoP to remain comfortably in surplus, allowing Sri Lanka to further build reserves.

LKR to remain stable, given the central bank's preference

The Central Bank of Sri Lanka (CBSL) has a preference for LKR stability. We believe that despite strong BoP position the LKR will be an underperformer in the region as the CBSL continues to absorb inflows. We expect USD/LKR to drift lower to 110 by end-2011 and 108 by end-2012.

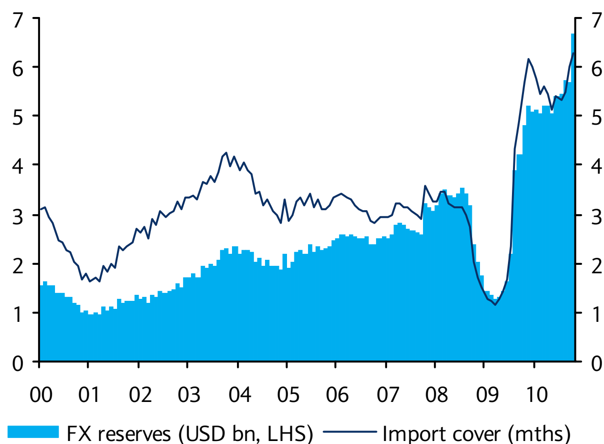
Rising inflationary pressures…

Inflationary pressures continue to build, with the 3m/3m saar rising to 12.4% in November from a recent low of -2% in June. In year-on-year terms, inflation rose to 7% in November, the highest since February 2009. Inflation is Sri Lanka is very sensitive to global commodity prices, especially food, as the country imports the bulk of its wheat, sugar and dairy needs. *The Economist* food price index typically serves as a good leading indicator of food inflation – the correlation between the two series is 0.70. Figure 4 suggests that food prices in Sri Lanka are biased higher, although the rice harvest in March-April may offer some respite. Overall, we expect inflation to hit 9% by March, rise to 11% in June, before subsiding to end 2011 at 8.7%. We expect inflation to average 9.6% in 2011, up from 6% in 2010.

… we expect the CBSl to begin the rate hike cycle in Q2 11

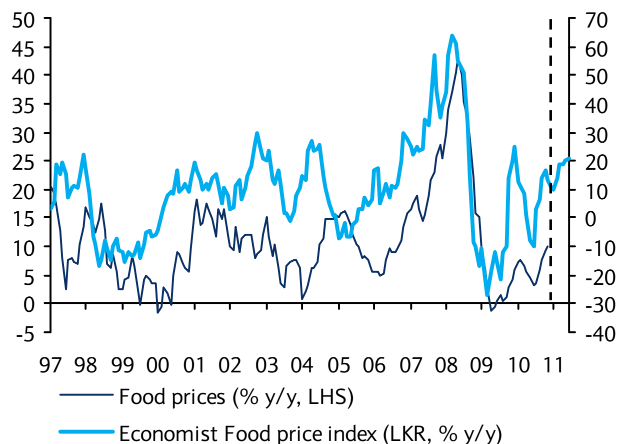
Given rising price pressures, we believe the CBSL will need to start signalling some tightening to ensure that inflation expectations remain anchored. However, some policy action ultimately will be needed, and we now expect the CBSL to hike the policy rate by 25bp, to 9.25% in Q2 11 (previously Q3), with a follow-up hike in the third quarter. The main risk to our rate forecast stems from a greater toleration by the CBSL for LKR appreciation in the face of rising imported prices.

Figure 3: FX reserves hit another historical high



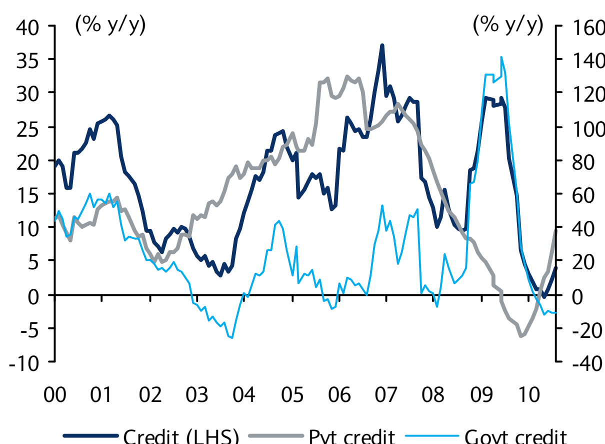
Source: CEIC, Barclays Capital

Figure 4: Food price inflation to rise further



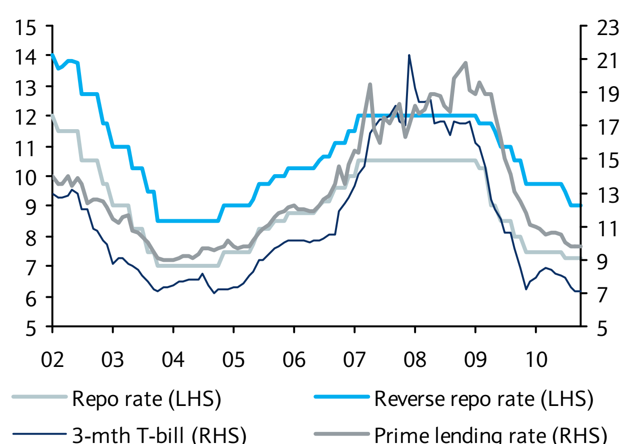
Source: CEIC, Barclays Capital

Figure 5: Private sector credit growth taking off…



Source: CEIC, Barclays Capital

Figure 6: …given supportive monetary policy (%)



Source: CEIC, Barclays Capital

Figure 7: Sri Lanka macroeconomic forecasts

	2007	2008	2009F	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.8	6.0	3.5	7.5	6.8	7.0
Domestic demand contribution (pp)	5.9	7.5	3.8	8.9	8.4	8.7
Private consumption (% y/y)	4.5	7.9	3.6	8.0	7.2	7.0
Fixed capital investment (% y/y)	9.1	5.3	1.0	8.5	11.0	11.0
Net exports contribution (pp)	0.9	-1.6	-0.2	-1.4	-1.6	-1.7
Exports (% y/y)	7.3	0.4	-12.3	4.3	6.5	7.0
Imports (% y/y)	3.7	4.0	-9.1	7.0	9.2	9.5
GDP (USD bn)	31	39	40	50	59	69
External sector						
Current account (USD bn)	-1.4	-3.9	-0.2	-1.5	-1.7	-1.8
CA (% GDP)	-4.5	-10.1	-0.5	-3.0	-2.8	-2.7
Trade balance (USD bn)	-3.7	-5.9	-3.1	-5.0	-5.6	-6.4
Net FDI (USD bn)	0.5	0.7	0.4	0.8	1.2	1.5
Other net inflows (USD bn)	1.6	1.1	2.2	2.4	2.2	2.0
Gross external debt (USD bn)	16.5	17.8	20.9	24.0	25.7	27.0
International reserves (USD bn)	3.1	1.8	5.1	6.8	8.2	9.5
Public sector						
Public sector balance (% GDP)	-7.2	-7.4	-10.3	-8.5	-7.0	-6.0
Primary balance (% GDP)	-1.9	-2.3	-3.6	-2.2	-1.6	-1.3
Gross public debt (% GDP)	89.1	85.3	90.5	84.8	79.2	74.0
Prices						
CPI (% Dec/Dec)	18.8	14.4	4.8	7.5	8.7	7.2
FX, eop	108.7	113.0	114.4	111.2	110.0	108.0
	1y ago	**Last**	**1Q11F**	**2Q11F**	**3Q11F**	**4Q11F**
Real GDP (% y/y)	6.2	7.3	7.2	6.5	6.6	6.7
CPI (% y/y, eop)	4.8	7.5	9.0	11.0	10.0	8.7
FX (domestic currency/USD, eop)	114.4	111.2	111.0	111.0	110.5	110.0
Overnight policy rate (%, eop)	9.75	9.00	9.00	9.25	9.50	9.50

Source: CEIC, Barclays Capital

EMERGING ASIA: TAIWAN

Structural transformation – phase 2

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The economic integration story is intact, setting the stage for more capital inflows next year, mainly into equities and property. We expect the pace of cross-straits engagement to accelerate ahead of general elections in 2012. Our 12m TWD forecast is 28/USD.

Cross-straits economic engagement to accelerate in 2011

Victory in the recent mid-term elections has given the KMT government a clear mandate to push ahead with closer economic ties with China. One catalyst is the proposed economic cooperation committee, which will speed up the implementation of initiatives related to the Economic Cooperation Framework Agreement (ECFA) and could be set up as early as December. ECFA may expand to include autos, more petrochemicals, steel and textiles, potentially adding 200 line items to the 800 products that will be tariff free from 2011. Economic integration will not be confined to China. Taiwan may also sign free trade pacts with New Zealand and Singapore – as early as Q1 11 – and initiate talks with the EU.

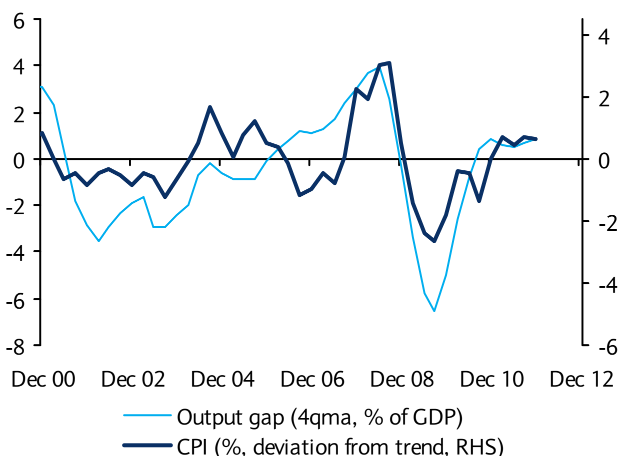
Taiwan's value proposition continues to improve

Taiwan's appeal as an investment destination has been augmented by the recent cut in its corporate tax rate (from 20% to 17%) and improved connectivity with China. At the same time, with labour costs rising quickly in China, the cost differential across the straits is narrowing. In 2011, we expect a rising inflow of capital from Mainland direct investors into Taiwan and the outward relocation of heavy industry to China to start to slow. As a result, we forecast a financial account surplus of 1.5% of GDP in 2011, which will add to the current account surplus of 5.7%. Reserve accumulation should also give way to further appreciation in the TWD, which we expect to strengthen to 28/USD in 12m.

CBC expected to hike rates by another 12.5bp, with little impact on market rates

We expect the central bank to continue its cautious tightening stance. Fuelled by the strong tonic of low interest rates and ample liquidity, it is clear from the Q3 GDP report the economy has enjoyed a robust cyclical recovery, leading us to raise our 2010 growth forecast to 10.3% from 9%, which would mark the strongest pace of growth since 1989. With the output gap likely to remain positive in 2011, we believe the CBC will continue to normalise policy and at its December Board meeting push up rates by 12.5bp, to 1.625% (partly to tame property prices). Similar to the previous two rate hikes, we believe the pass-through into market rates will be minimal.

Figure 1: Economy will remain at full potential in 2011



Source: CEIC, Barclays Capital

Figure 2: Policy focus on taming property prices

Source: CEIC, Barclays Capital

Growth also of better quality, led by domestic demand

Delving into the details of the 3Q GDP report, we note that growth was of higher quality, with an improving transmission from exports into domestic demand. Private consumption contributed 2.55ppt to growth in Q3, supported by stronger discretionary spending. Private investment contributed 4.36ppt, the same as in Q2, which more than offset the small drag from public capital formation. This is an indication that the pro-cyclical kick from fiscal spending this year is weaker than expected, as spending streams from the multi-year i-Taiwan infrastructure programme are only likely to come through in Q1 2011.

High frequency data is likely to slow in Q4 before gradually picking up in Q1 11

Meanwhile, high frequency indicators remain on a downward trajectory in line with the slowing global electronics cycle. In trend terms, industrial activity continues to slow with the 6m/6m momentum (seasonally adjusted) falling to 3.5% - the lowest reading since July 2009 and compared with a peak of 44.7% in February this year. Although we saw a positive surprise in October exports, this was due to the peak shipping season - just ahead of the year-end festive sales in G3 markets. However, PC makers expect to begin shipping notebooks with the new Intel (Sandy Bridge) platforms in December and launch new PC products in Q1 2011. We believe electronics output fell in October and November, as PC makers made the transition between platforms, but look for a gradual resurgence in activity and shipments starting from Q1 2011.

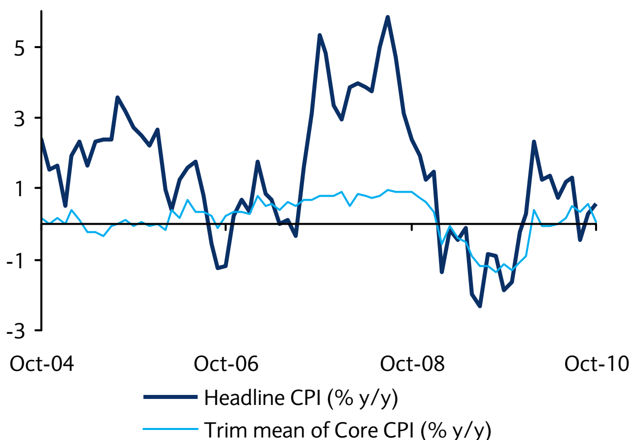
Inflation will remain benign

Inflation is less of a concern. Temporary shocks like weather-related disruptions are driving headline inflation at the moment, mainly through the food component. In seasonally adjusted m/m terms, the inflation picture remains benign - the CPI rose just under 0.1% in October, after rising by the same amount in September. Core CPI climbed 0.48% m/m in October, although in seasonally adjusted terms, it receded 0.08%. We expect prices to rise 1.6% in 2011 (0.9% in 2010).

We do not believe capital controls will deter investment into Taiwan

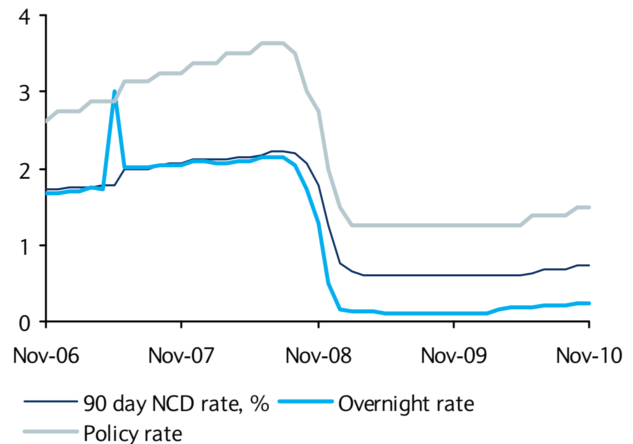
We believe the 10 November ban on FINI accounts from freely placing funds in government bond markets will have a modest impact on investor sentiment and the TWD. If anything, the move appears to be diverting cash balances held by FINI investors into equities, not necessarily out of the country. There were also suggestions from opposition parliamentarians about imposing a Brazil-style tax on capital inflows. However, we believe that the authorities would tread much more cautiously on measures that could potentially affect foreign investment in the equities market.

Figure 3: Inflation is a lesser concern



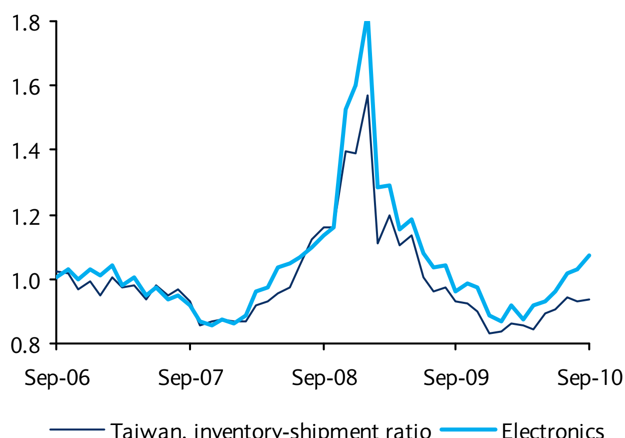
Source: CEIC, Barclays Capital

Figure 4: Rate hikes having reduced impact on market rates



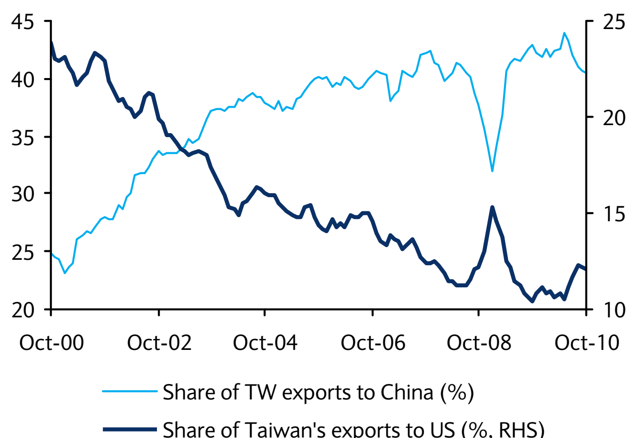
Source: CEIC, Barclays Capital

Figure 5: Rise in I/S ratio signals slower IP momentum



Source: CEIC, Barclays Capital

Figure 6: China is now the focus of policymakers



Source: CEIC, Barclays Capital

Figure 7: Taiwan macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.0	0.7	-1.9	10.3	4.0	4.5
Domestic demand contribution (pp)	1.3	-1.5	-3.7	8.7	3.2	3.5
Private consumption (% y/y)	2.1	-0.6	0.7	4.1	3.2	3.2
Fixed capital investment (% y/y)	0.6	-11.2	-12.2	23.5	10.6	8.5
Net exports contribution (pp)	4.6	2.3	1.8	1.6	0.9	1.0
Exports (% y/y)	9.6	0.6	-8.4	24.2	5.0	3.2
Imports (% y/y)	3.0	-3.1	-13.4	27.8	4.7	2.4
GDP (USD bn)	393	401	378	432	499	549
External sector						
Current account (USD bn)	35.2	27.5	42.9	37.8	28.5	32.8
CA (% GDP)	8.9%	6.9%	11.4%	8.7%	5.7%	6.0%
Trade balance (USD bn)	30.4	18.5	30.6	27.1	23.5	23.0
Net FDI (USD bn)	-3.3	-4.9	-3.1	-7.8	0.8	3.0
Other net inflows (USD bn)	-35.6	3.2	16.6	18.0	6.8	7.0
Gross external debt (USD bn)	94.5	90.4	82.0	90.0	93.0	95.0
International reserves (USD bn)	270.3	291.7	348.2	395.0	425.0	460.0
Public sector						
Public sector balance (% GDP)	0.3	-0.7	-4.1	-2.5	-1.9	-1.0
Gross public debt (% GDP)	28.8	29.8	33.1	34.1	32.9	30.0
Prices						
CPI (% Dec/Dec)	3.3	1.3	-0.2	1.4	1.7	2.0
FX, eop	32.4	33.2	31.75	30.00	28.0	28
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	9.2	9.8	5.8	3.0	3.5	4.7
CPI (% y/y, eop)	-1.3	0.4	1.0	1.7	1.5	1.7
FX (domestic currency/USD, eop)	32.80	30.96	30.00	29.50	29.00	28.50
Base rate (%, eop)	1.2500	1.5000	1.6250	1.7500	1.8750	2.0000
Market implied rate (%, eop)	0.11	0.22	0.26	0.30	0.35	0.40

Source: Barclays Capital

EMERGING ASIA: THAILAND

Normalising in a noisy environment

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The Bank of Thailand has indicated its desire for a less accommodative monetary policy stance to counter rising input costs. Risks of more restrictive measures on capital inflows remain, which we believe may slow the pace of inflows but are unlikely to prevent further baht strength. We now expect THB to reach 29/USD in 12 months.

THB, the best performing currency in EM Asia in 2010

The Thai baht has been the best performing EM Asian currency in 2010, with strong appreciation in H2 10. This outperformance has been a result of increased inflows into the local currency bond and equity markets. In addition, current account surpluses have been growing in size, leading to rapid foreign reserves accumulation. Currency strength has sparked concerns from exporters and Thai industry bodies worried about competitiveness. In October, under pressure to stem the currency's appreciation, the Ministry of Finance announced it was withdrawing foreign investors' exemption from the 15% withholding tax on income from Thai government bonds.

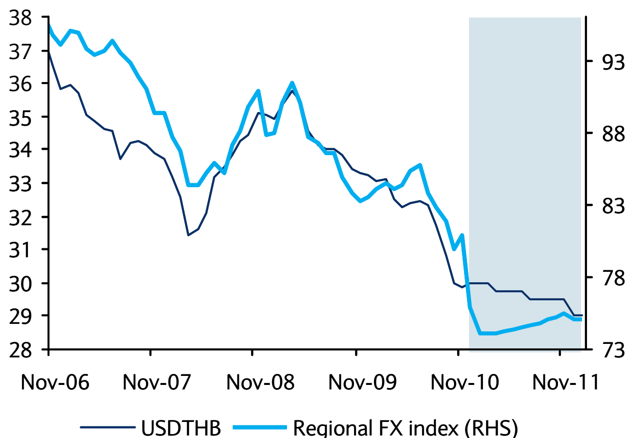
Policymakers aim to moderate the pace of appreciation, but not the direction

We do not believe the central bank is planning to impose stricter capital controls. Indeed, BoT governor Prasarn Trairatvorakul has noted that pressure on the baht had eased and there was no immediate need for more measures. The focus is likely to shift back to encouraging outflows and helping to internationalise the Thai economy. In short, the BoT has kept its options open, while indicating that it may consider imposing a 'Tobin' tax on currency transactions if the pace of appreciation is deemed unreasonable.

Strong external balance should ensure ongoing albeit moderate currency gains. We see THB at 29/USD in 12 months

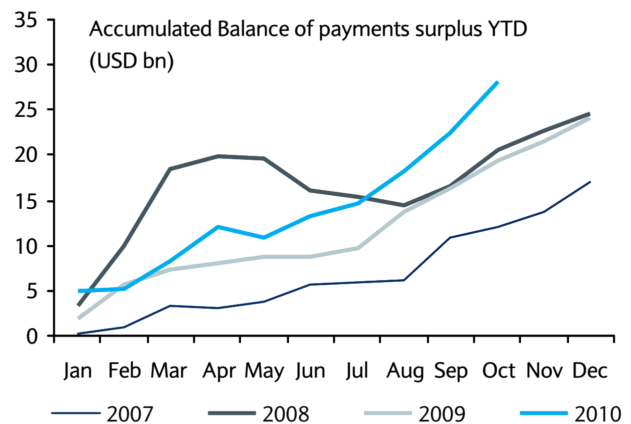
Policymakers realise they cannot reverse the appreciation trend, but they wish to avoid speculative excesses. We see the appreciation pressures as fundamentally driven, primarily coming from large balance of payments surpluses. Even with the withholding tax, portfolio inflows have continued into the government bonds, albeit at a slower pace. FDI inflows have increased and there has been a moderation in intermediate imports compared with exports, resulting in a widening trade surplus. That said, we expect the balance of payments surplus to shrink to USD22.1bn in 2011, from USD30.4bn in 2010, driven by a resumption of the investment cycle and rising import costs. We expect the THB to show consistent but modest appreciation, with 29.0/USD being our 12m target.

Figure 1: THB continues to move in line with the region



Source: CEIC, Barclays Capital

Figure 2: Pressure remains on THB to appreciate



Source: CEIC, Barclays Capital

Bank of Thailand appears concerned over rising input costs and wages in the economy

Prime Minister Abhisit recently advocated support for a rise in minimum wages, which would be the largest since 1993. This will most likely lead to increased input costs for businesses heavily dependent on low-skilled labour. On top of that, higher wages or expectations of higher wages in general tend to lead to a jump in private consumption, thus stoking demand-side pressures. The central bank has clear concerns about rising input costs, which may eventually feed into core price pressures.

Rising raw material prices and a reviving real estate market may be another cause of concern. We see the BoT hiking policy rates by another 50bp in 1H 2011

Rising raw material prices are also an issue. The small but persistent increases in raw material and energy prices are raising business costs, which will eventually feed into consumer prices. This is likely to happen in tandem with a reviving real estate market in urban areas, which could face cost pressures from rising metal and cement prices. Overall, we expect the Bank of Thailand to hike its policy rate twice in H1 11, by 25bp each time. We expect the first hike in Q1, with the timing data dependent. Given that there have already been four consecutive declines in monthly private consumption and two months of declines in investment, we expect the BoT to hike rates gradually.

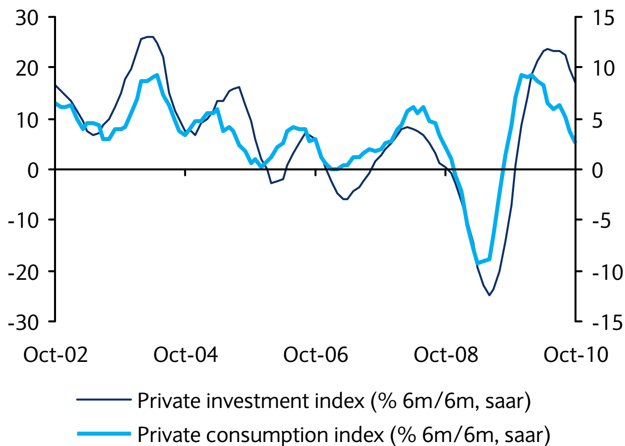
BoT is likely to pay close attention to interest rate differentials and market volatility in its monetary policy decisions

The BoT is walking a tightrope in withdrawing its monetary stimulus while ensuring there is no major impact on the THB. The issue has been further compounded by increased financial market volatility and the re-emergence of growth risks in the euro area. We view the surprise rate hike at the 1 December meeting as indicating the central bank's desire to make a gradual exit from its "extra-accommodative" monetary stance. The central bank expects growth momentum to pick up again in Q4, given the strong boost from higher commodity prices and a revival in sentiment-sensitive industries such as tourism.

Elections are due next year, which means an increase in political activity in 2011

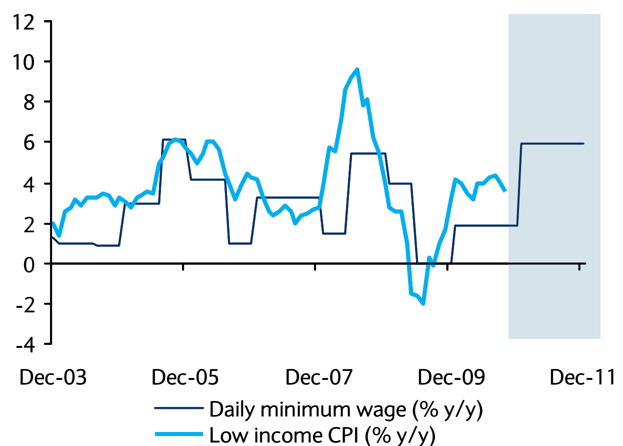
On the political front, the governing coalition led by the Democratic Party has strengthened its position after election fraud charges against its top leaders were dismissed by the Constitutional Court. Since the April-May political demonstrations, political risks have eased, resulting in a re-weighting of political risk, as is evident in Moody's change in outlook from Negative to Stable in late October. The government maintains its intention to hold a general election in late 2011. Upcoming by-elections on 12 December are likely to be a good litmus test of the government's popularity and aggressive economic agenda. The opposition forces, the so-called "Red shirts" are likely to start preparing for elections for late next year. While there could be a pick up in political dynamics, we do not expect a major escalation in tensions.

Figure 3: Even as high frequency indicators moderate…



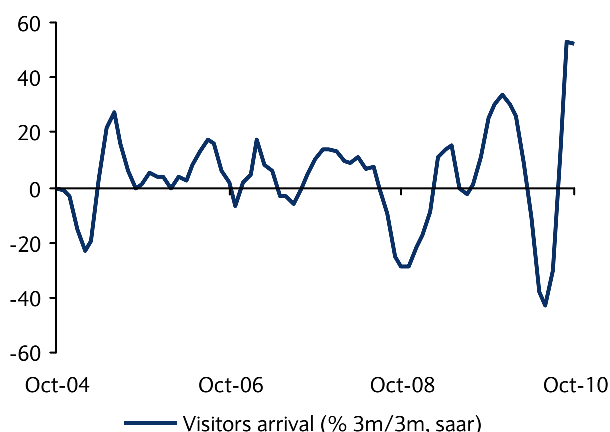
Source: CEIC, Barclays Capital

Figure 4: …BoT remains concerned about rising input prices



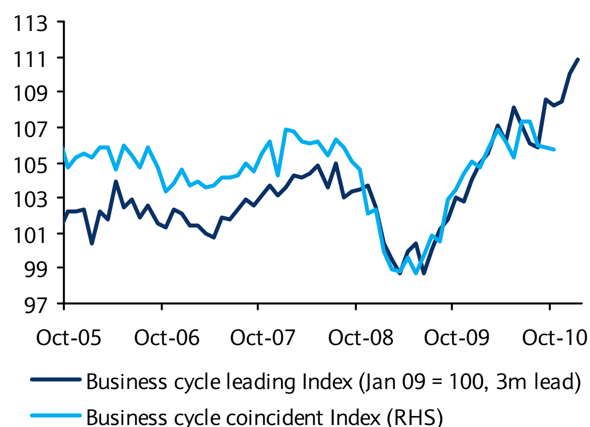
Source: CEIC, Barclays Capital

Figure 5: As labour intensive industries are doing well…



Source: CEIC, Barclays Capital

Figure 6: …and leading indicators point to a quick recovery



Source: CEIC, Barclays Capital

Figure 7: Thailand macroeconomic forecast

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	5.0	2.5	-2.3	8.0	4.0	6.0
Domestic demand contribution (pp)	2.0	3.6	-5.9	8.0	3.5	4.6
Private consumption (% y/y)	1.8	2.9	-1.1	5.0	4.8	5.8
Fixed capital investment (% y/y)	1.5	1.2	-9.2	9.0	5.0	2.9
Net exports contribution (pp)	2.9	-1.2	3.4	0.0	0.9	1.3
Exports (% y/y)	7.8	5.1	-12.5	14.3	5.5	7.5
Imports (% y/y)	4.4	8.9	-21.5	19.9	5.5	7.4
GDP (USD bn)	247	272	264	310	354	392
External sector						
Current account (USD bn)	15.8	2.2	21.9	12.4	10.6	6.0
CA (% GDP)	6.4	0.8	8.3	4.0	3.0	1.5
Trade balance (USD bn)	12.8	-0.4	19.4	12.4	11.4	7.5
Net FDI (USD bn)	8.3	4.4	0.9	4.1	3.5	5.0
Other net inflows (USD bn)	-8.1	7.7	-3.7	14.5	6.0	-4.0
Gross external debt (USD bn)	74.4	76.1	75.3	88.5	93.0	99.0
International reserves (USD bn)	87.0	111	138	173	193	200
Public sector						
Public sector balance (% GDP)	-1.7	-1.1	-4.4	-2.0	-2.3	-1.8
Gross public debt (% GDP)	38.9	37.6	43.9	42.0	41.0	39.5
Prices						
CPI (% Dec/Dec)	3.2	0.4	3.5	3.1	3.3	1.8
FX, eop	33.7	35.0	33.2	30.0	29.0	28.0
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	5.9	6.7	4.3	1.7	5.1	3.7
CPI (% y/y, eop)	3.5	2.8	3.1	3.0	2.6	3.0
FX (domestic currency/USD, eop)	33.3	30.8	30.0	29.75	29.5	29.00
Overnight policy rate (%, eop)	1.25	2.00	2.00	2.25	2.50	2.50

Source: Barclays Capital

EMERGING ASIA: VIETNAM

Building pressures

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Vietnam's Communist Party Congress provides an opportunity for improvement in policy management. However, given rising inflation and some widening in the trade deficit, we continue to expect USD/VND to end Q1 11 at 19,800. We also expect the central bank to hike the policy rate by 200bp, to 11%, in H1 11. FDI and remittances continue to provide fundamental support to the balance of payments, but resident leakages remain large.

National Congress in January…

… we expect the composition of Political Bureau to change…

… and see the possibility of some new thinking

Elections are going to take centre stage in Vietnam, with the 11th National Congress slated for January 2011. The last congress was held in 2006, with the Communist Party having been established in 1930. The National Congress is an important forum for policy changes and choosing leaders. In our view, the most likely changes will involve the composition of the Political Bureau – roughly one-third of its 15 members will retire after January 2011. Also, natural attrition means that the decade-old policy of distributing the three most important seats equally by region (ie, General Secretary to the north, Prime Minister to the south and State President, to the central region) will probably be difficult to follow. These changes open up the possibility of new thinking and perhaps some positive developments. Once the congress is completed, there will be more clarity on the main ministerial posts – Ministry of Finance, State Bank of Vietnam and Ministry of Planning and Investment. This could mean the end of policy limbo and more action to address important issues – pressure on the currency and rising inflation.

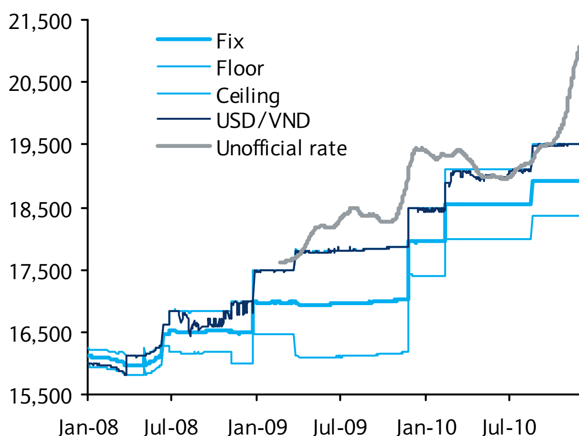
We forecast the VND will end Q1 11 at 19,800

The State Bank of Vietnam has kept the dong stable at 19,500 since the 2.1% weakening in mid-August. However, the unofficial rate continues to trade at a premium to the official rate, suggesting ongoing pressures, which we believe largely reflect onshore concerns about possible depreciation. The central bank has indicated that there will be no depreciation in the near term. We believe that for expectations to be contained, a more active SBV presence in the interbank dollar market is needed. Given accelerating inflation and some likely widening in the trade deficit into 2011, we maintain our view that USD/VND will end Q1 at 19,800.

FDI and remittances to more than cover annual trade deficit…

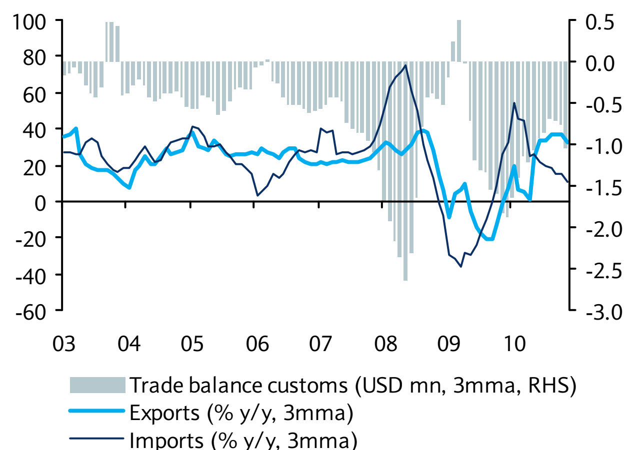
Vietnam's customs trade deficit was USD10.6bn during January-November 2010, on track to meet our annual forecast of USD12bn, compared with a shortfall of USD10.4bn in the year-earlier period and a deficit of USD15.8bn in 2008. On a rolling three-month basis, the

Figure 1: USD/VND spot versus band



Source: Reuters, Bloomberg, Barclays Capital

Figure 2: Trade deficit widened slightly



Source: CEIC, Barclays Capital

… but SBV Governor Giau recently stated that the BoP probably posted a deficit of USD2bn in 2010

deficit widened slightly to USD1bn. The deficit is more than covered by structural inflows – FDI of USD9bn and remittances of USD7.5bn. However "leakages" from residents suggest that the full strength of the inflows is unlikely to be reflected in reserve figures. Estimating leakages is rather difficult as Vietnam does not publish quarterly BoP statistics. However, central bank governor Giau recently said that the BoP will likely see a deficit of USD2bn in 2010, pressuring FX reserves. For 2011, we project a customs trade deficit of USD14bn, more than covered by FDI of USD9.5bn and remittances of USD8.4bn.

GDP growth to average 6.8% in 2010 and 7.2% in 2011

GDP growth accelerated to 7.4% y/y in Q3 10 from 6.3% in Q2. With November YTD retail sales up 25% y/y, the outlook for consumer spending remains strong. Exports have started to moderate in line with external demand; however, the low-cost nature of Vietnam's products should continue to offer some support. We remain comfortable with our GDP forecast of 6.8% for 2010 and 7.2% for 2011.

Inflation pressures are rising…

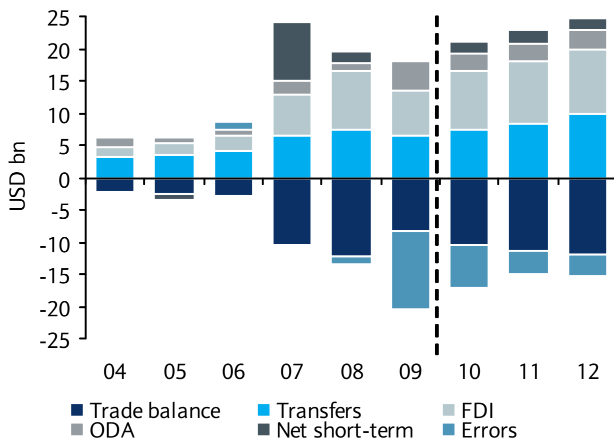
… we expect CPI inflation to hit 13% in March and 15% in June

Inflation momentum in Vietnam has picked up, with the 3m/3m saar running at 16.5% in November compared with a recent low of 0.8% in August. In y/y terms, inflation hit a 20-month high of 11.1%. The bulk of the impetus has come from food, given floods in central Vietnam and elevated global food commodity prices. We expect price pressures to continue to rise into 2011, with Q1 tending to be a period of high inflation, given the Tet (Lunar New Year) holiday in early February. At the same time, we continue to expect USD/VND to drift to 19,800 in Q1, which according to our estimates will add roughly 25bp to inflation. Overall, we believe that inflation will hit 13% by March and rise to 15% by June, before subsiding to end 2011 at 12%. We expect inflation to average 13.5% in 2011, up from 9.2% in 2010. The main risks to our inflation forecast come from global commodity prices – food and oil. Markets have been focusing on rising inflation and expectations of VND depreciation, and we believe these concerns can apply some pressure on Vietnamese government bond yields and credit spreads.

We expect the SBV to hike the policy rate by at least 200bp in H1 11

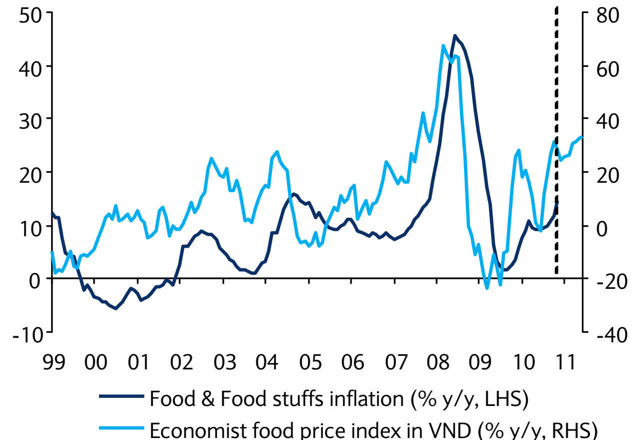
In terms of policy, the double-digit inflation print will continue to put pressure on the central bank and the currency. The State Bank of Vietnam last hiked the policy rate 100bp, to 9%, in early November. This has been passed through in the economy, with lending interest rates moving to roughly 19% from 15-17% previously. The government has also imposed price controls for key commodities, including electricity, coal for power production, cement and fertiliser. However, we think more tightening is needed and expect the central bank to hike the policy rate at least 100bp in Q1 11, followed by another 100bp increase in Q2.

Figure 3: Robust FDI and remittances



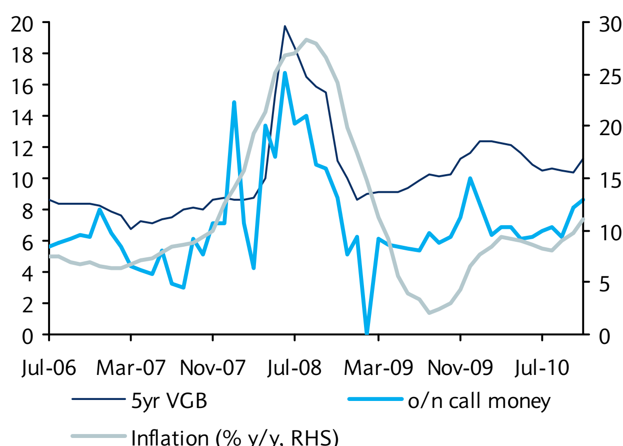
Note: ODA is overseas development assistance. Source: CEIC, Barclays Capital

Figure 4: Food prices are biased higher



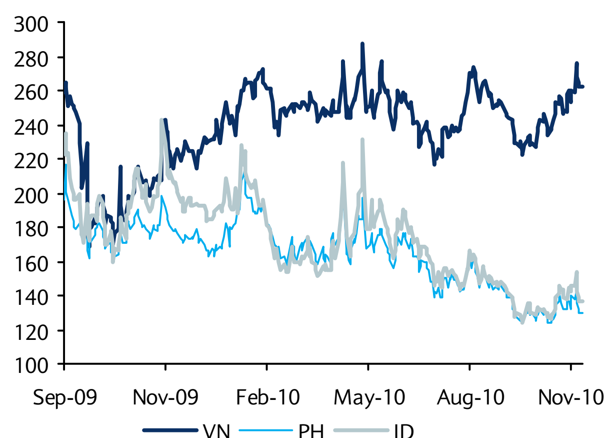
Source: CEIC, Barclays Capital

Figure 5: Rising inflation to pressure VGB yields



Source: Bloomberg, Barclays Capital

Figure 6: Vietnam 5y CDS vs Indonesia and Philippines



Source: Bloomberg, Barclays Capital

Figure 7: Vietnam macroeconomic forecasts

	2007	2008	2009F	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	8.5	6.2	5.3	6.8	7.2	7.5
Domestic demand contribution (pp)	17.7	9.4	5.0	9.5	11.1	10.9
Private consumption (% y/y)	10.8	9.3	3.7	7.6	8.8	9.0
Fixed capital investment (% y/y)	24.2	3.8	8.7	9.3	10.3	10.5
Net exports contribution (pp)	-13.2	-3.2	1.7	-2.0	-2.9	-3.2
Exports (% y/y)*	21.9	29.5	-9.2	18.9	16.1	20.1
Imports (% y/y)*	38.3	27.6	-13.0	20.0	14.9	18.1
GDP (USD bn)	71	90	93	102	118	136
External sector						
Current account (USD bn)	-7.0	-9.2	-7.4	-9.1	-9.7	-9.6
CA (% GDP)	-9.8	-10.2	-8.0	-8.9	-8.2	-7.1
Trade balance (USD bn)#	-10.4	-12.3	-8.3	-10.6	-11.4	-11.9
Net FDI (USD bn)	6.6	9.3	6.9	9.0	9.5	10.0
Other net inflows (USD bn)	11.0	3.1	4.6	4.6	4.9	4.9
Gross external debt (USD bn)	23.1	28.4	36.5	42.0	48.0	54.0
International reserves (USD bn)	23.5	23.0	16.0	14.0	15.0	16.5
Public sector						
Public sector balance (% GDP)	-5.6	-5.0	-9.0	-7.0	-6.5	-6.0
Primary balance (% GDP)	-4.5	-3.4	-5.5	-5.6	-5.3	-5.0
Gross public debt (% GDP)	45.7	43.9	49.2	52.1	50.5	48.2
Prices						
CPI (% Dec/Dec)	12.6	19.9	6.5	11.5	12.0	9.8
FX, eop	16,017	17,483	18,500	19,500	20,100	20,400
	1 yr Ago	**Last**	**10Q4F**	**11Q1F**	**11Q2F**	**11Q3F**
Real GDP (% y/y)	7.7	7.4	7.5	6.5	6.8	7.4
CPI (% y/y, eop)	6.5	8.9	11.5	13.0	15.0	13.0
FX (domestic currency/USD, eop)	18,500	19,500	19,500	19,800	20,100	20,100
Overnight policy rate (%, eop)	8.00	8.00	9.00	10.00	11.00	11.00

Note: *Nominal as real data not available. # Balance of payments basis, not customs basis. Source: Barclays Capital

EMEA: BALTIC STATES – ESTONIA, LATVIA, LITHUANIA

Recovery

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After large adjustments over the past 8-10 quarters, all three Baltic states have exited recession. The recovery is led by export expansion helped by robust external demand but also impressive competitiveness (re-)gains. The unwinding of the private sector debts and reduction of large fiscal deficits (not in Estonia) will take longer and continue to pose the main risk. However, positive growth makes this adjustment much easier. Estonia, which has set itself apart in the boom and the bust, will adopt the euro in January – giving it one of the healthiest fiscal positions in the euro area.

Strategy:
Credit – switch from Croatia 19s, 20s into Lithuania 17s, 20s

Strategy: The economic stabilisation in the Baltic region is reflected in recent spread performance. Compared with the volatile spread performance in other parts of the CEE region over the past few weeks, volatility in Baltic spreads has remained comparatively contained. While fiscal adjustment needs are still sizeable in Latvia and Lithuania, the commitment to the internal devaluation path and signs of success of this strategy justify the robust performance, in our view. Challenges remain, but the Baltic countries are unlikely to be among the weakest links in the CEE region over the next quarter. In contrast to Croatia, for example, the Baltic region is likely to benefit strongly from the recovery in global trade. Moreover, the region's banking sector links with Scandinavia, rather than Western and Southern Europe, should leave it in a comparatively robust position regarding knock-on effects from weakness in the European banking sector. Against this background, we see better value in Baltic credit than in most other parts of the CEE region at present and recommend switching from the Croatia 19s and 20s into Lithuania 17s and 20s, in particular.

Estonia: The euro area's new role model

Estonia to become the euro area's fiscal model child

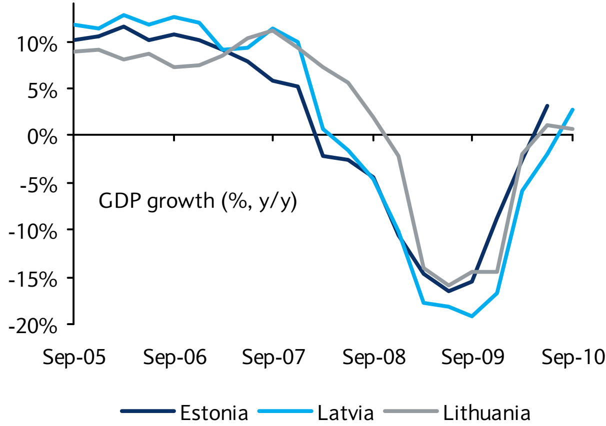
Estonia will adopt the euro in January 2011. This will move Estonia out of our EM coverage and add a country to the euro area, whose fiscal discipline credentials should make it Berlin's 'Musterknabe' – the model child for the fiscally responsible euro area Germany hopes to create. Maintaining a 1.7% of GDP deficit during a 14% GDP contraction in 2009 helped it to maintain a debt-to-GDP ratio of just 8% – a clear outlier in today's euro area.

Estonia's economy has benefited from the external demand rebound…

… and from confidence boost due to forthcoming euro entry

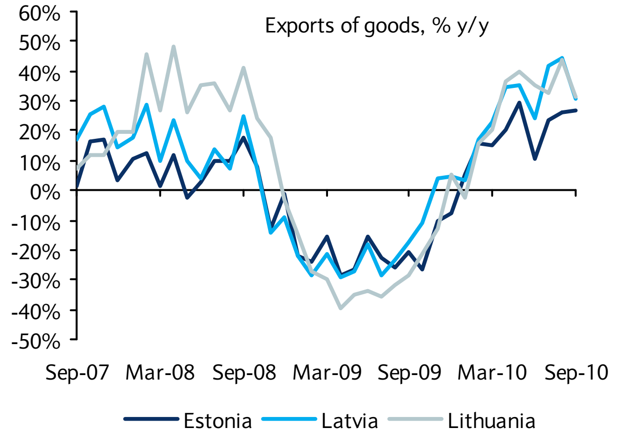
As in the rest of the region, external trade has made the main contribution to growth thus far, as Estonia's main export partners (incl. Sweden, Finland, but also other euro area economies, the other Baltics and Russia) have been recovering. The flexible nature of the Estonian economy has allowed it to benefit promptly from this external demand rebound. The adjustment in costs that took place in 2009 also contributed to the improved competitiveness of the economy, allowing Estonia to increase its share in global trade. Consumption and investment have remained muted thus far, but are expected to contribute to growth in 2011, moving the growth rate from about 2.5% this year to over 4% in 2011. This improved domestic demand should reduce the large current account surplus over time (we project the surplus to reach over 4% in 2010). As we opined earlier, the main potential challenges for Estonia will be to avoid overheating and to avoid the erosion of competitiveness once the goal of euro adoption is achieved. After posting very low inflation in 2009, headline inflation has been on an upward trend since the beginning of 2010. However, thus far the increases seem mostly related to surges in energy prices, including hikes in excise duties, and more recently food prices, exacerbated by growing food exports to Russia, following a poor harvest there due to weather conditions in the summer.

Figure 1: Output is expanding again…



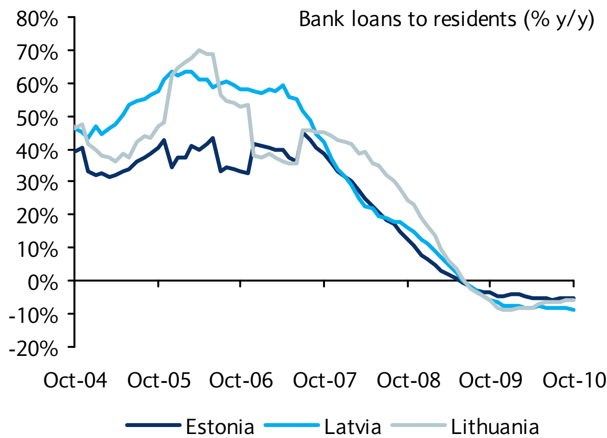
Source: National statistic offices, Haver Analytics, Barclays Capital

Figure 2: … still driven by exports…



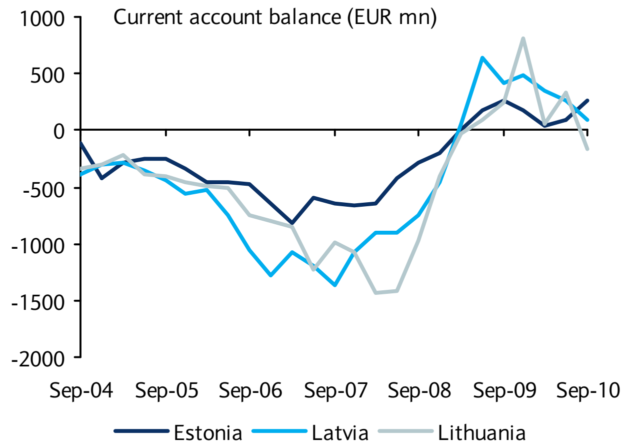
Source: National statistic offices, Haver Analytics, Barclays Capital

Figure 3: … while lending is flat-lining in negative territory



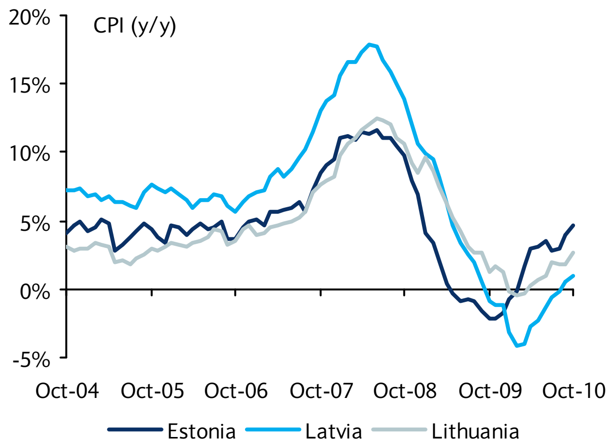
Source: National statistic offices, Haver Analytics, Barclays Capital

Figure 4: Current accounts seem to move sideways…



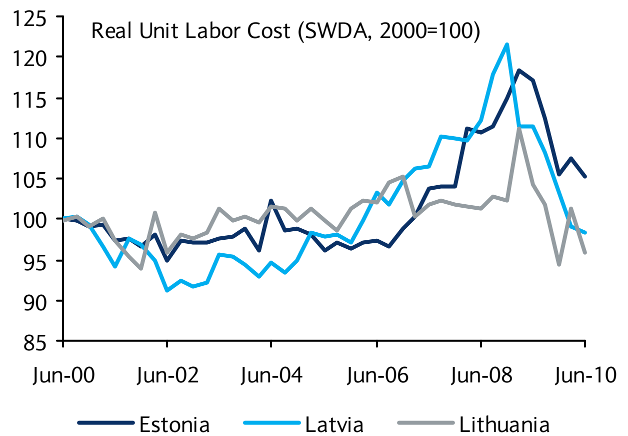
Source: National statistic offices, Haver Analytics, Barclays Capital

Figure 5: … and inflation is also on the rise again…



Source: National statistic offices, Haver Analytics, Barclays Capital

Figure 6: … but real ULC adjustments have been massive



Source: Eurostat, Haver Analytics, Barclays Capital

Estonia's EUR adoption should send a positive signal to other aspirants with fixed currency regimes

Overall, we believe Estonia should do well in the euro area, given that it has successfully managed its economy under a fixed exchange rate regime since the early 1990s. As we noted before, seeing a country adopt the euro during the gravest euro area crisis should send a positive signal to the other small EU countries with fixed currency regimes that access is not impossible. For Lithuania, perhaps more than Latvia, the goal of euro adoption in 2014 may no longer appear overly optimistic.

Latvia: Stabilisation followed by growth

Economy exited recession earlier than expected

Growth could be close to zero this year and over 3% in 2011

Latvia's economy recorded three consecutive periods of q/q growth in 2010 and technically moved out of recession – one or two quarters earlier than previously expected. Exports performed well on strong demand from all major trade partners. However, beyond foreign demand, large reductions in labour costs and real effective exchange rate depreciations also provided support. Not unexpectedly, domestic demand has remained weak thus far. However, import and retail data in Q3 signalled that the healthy export performance started to have positive effects on consumption and investment. Thus, while exports will have to remain the main pillar of the recovery, the composition of growth is expected to become more balanced in 2011. As export-oriented manufacturers look to upgrade production capacities, investment should pick up substantially in 2011, also supported by improving conditions in the banking sector. Consumption is likely to take longer to rebound, but confidence has also improved and job creation should also support this (yet unemployment, still over 19%, is likely to remain in double digits for years). We estimate annual growth to be only slightly negative this year and to reach above 3% in 2011 and probably higher in 2012.

Current account could turn into small deficit again next year…

… but gross reserves stand at about 30% of GDP

With regard to external balances, the margin between exports and import growth has been slowing compared with 2009. As a result, we now expect the current account to move back into a small deficit by next year. Besides rising imports, this will also depend on foreign firms' incomes: while the losses booked in 2010 improved the income balance, the repatriation of potential profits in 2011 is likely to cause it to deteriorate again. The financial account remained in deficit in H1 10 but gross reserves nevertheless rose due to EU/IMF financing (to about EUR6bn, over 30% of GDP). Much of the committed bilateral Nordic loans are now treated as credit facilities and may not be drawn. FDI flows have been weak, but reduced uncertainties about Latvia's prospects could lead to some rebound in the coming quarters.

Re-election of government in October signalled continued commitment to adjustment

Given the continuing need for fiscal and structural reform, perhaps the most important event for Latvia was the general elections on 3 October. Contrary to common political economic reasoning, the government carrying out painful austerity measures was re-elected: the centre-right Unity Bloc, which made up a large part of the previous ruling coalition, won the largest share of votes (over 30%), turning a multi-party coalition into a two-party coalition. Hence, the government received the backing of the electorate for continuing the 'internal devaluation' strategy under the IMF-EU supported programme.

2011 budget adoption on 7 December

Fiscal deficit could drop below 6% in 2011

Recent EU commission reports suggest implementation of the 2010 budget thus far has been "satisfactory overall". It is expected that the 8.5% of GDP fiscal deficit ceiling can be met comfortably; indeed, an over-performance of 0.5-1.0pp is possible. The better-than-expected recovery is expected to support the additional fiscal consolidation needed in 2011. Depending on whether new IMF-EU-agreed measures are adopted in the budget on 7 December (budget preparations were delayed due to the October elections), the deficit could drop below 6% of GDP in 2011. Delays in the IMF's Art IV report and references by the EU commission to 'consolidation fatigue', however, suggest the new round of measures may have been met with some resistance by the government. Indeed, even after fiscal adjustments of roughly 15% of GDP, the additional efforts needed to reach the below-3% target in 2012 remain formidable.

Potential fiscal costs from financial sector measures

Although smaller than originally anticipated at the height of the crisis, potential financial sector costs (eg, related to the losses made by the 'bad bank', a legacy of the Parex intervention) could add to the government's liabilities. This makes the path of the government debt ratio, about 46% of GDP by end-2010, difficult to predict. Privatisations could help to offset some financial sector-related losses, but whether Latvia can keep the ratio below the Maastricht threshold of 60% in coming years is not yet clear. What is more certain is that despite the seemingly successful 'internal devaluation' strategy – something much of the euro periphery may take note of – it will still take years to work through the financial crisis balance sheet legacies.

Lithuania

We see Lithuania's recovery gaining momentum, despite the disappointing Q3 number

The recovery story of export driven growth, supported by improved cost competitiveness (in particular wage disinflation) and robust demand from main export partners (including Germany and Russia) is similar to that of the other Baltic countries. Lithuania's larger export base allows it to benefit from the global trade recovery even more than, for example, Latvia. Poor performance in the agricultural sector held Q3 growth down, lowering our annual growth forecast to below 1% this year. However, we see the recovery gaining momentum and broadening its base from net exports into investment and consumption, resulting in 3% growth or more in 2011. The current account surplus will decline in parallel, but we do not see a current account deficit emerging soon.

Fiscal adjustment needs are still significant

The need for continuing fiscal adjustment – achieved without IMF-EU help thus far – remains the country's key challenge. The government took fiscal measures of about 8% of GDP in 2009 and 3.7% in 2010 to contain the fiscal deficit, which is nevertheless expected to remain above 8% in 2010 (from 9.2% of GDP in 2009). In mid-2010, the government extended a number of temporary expenditure-saving measures, including reduced wages for politicians and government officials, as well as lower transfers of contributions to the second-pillar pension funds. Moreover, the very high maternity benefits – a point noted by the IMF mission – were reduced significantly. However, other expenditure items including interest payments, healthcare spending, capital expenditure and social benefits did increase in 2010.

Political resistance to additional fiscal measures could be a risk if revenues fall short

The draft 2011 budget targets a deficit of 5.8% of GDP, which is in line with the target agreed with the EU under the excessive deficit procedure (EDP). However, the budget relies on significant revenue increases due to robust growth and better tax compliance. While there are only a few increases in taxes and non-tax revenue, the PIT for self-employed is to be reduced to 5% (from 15%) in 2011. This could be a risk, but the draft budget also includes a contingency provision that requires a supplementary budget should revenues fall short of expectations. However, potential resistance to additional fiscal measures in such a situation remains a risk.

Figure 7: Baltic States (Estonia, Latvia, Lithuania) macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F	2007	2008	2009	2010F	2011F	2012F
	Real GDP (% y/y)						CPI (% average)					
Estonia	6.9	-5.1	-13.9	2.5	4.3	3.6	6.7	10.6	0.2	2.6	4.1	2.3
Latvia	10.0	-4.2	-18.0	-0.4	3.2	3.9	10.1	15.3	3.3	-1.3	1.1	1.8
Lithuania	9.8	2.9	-14.7	0.6	3.1	3.3	5.8	11.1	4.2	1.2	2.3	2.9
	Current account balance (% GDP)						External debt (% GDP)					
Estonia	-17.2	-8.5	4.5	4.1	1.4	0.9	102	119	132	129	125	120
Latvia	-22.3	-13.1	8.6	3.9	-0.4	-3.0	135	124	160	157	151	145
Lithuania	-15.1	-13.1	2.6	2.7	1.3	1.1	72	74	87	90	85	80
	General government balance (% GDP)						General government debt (% GDP)					
Estonia	2.5	-2.8	-1.7	-1.0	-2.0	-2.9	3.7	4.6	7.2	8.1	9.5	11.8
Latvia	-0.3	-4.2	-10.2	-7.7	-6.0	-5.3	9.0	19.7	36.7	45.7	51.9	56.6
Lithuania	-1.0	-3.3	-9.2	-8.4	-6.1	-6.9	16.9	15.6	29.5	37.4	42.8	48.3

Source: Barclays Capital

EMEA: BULGARIA

Rebalancing

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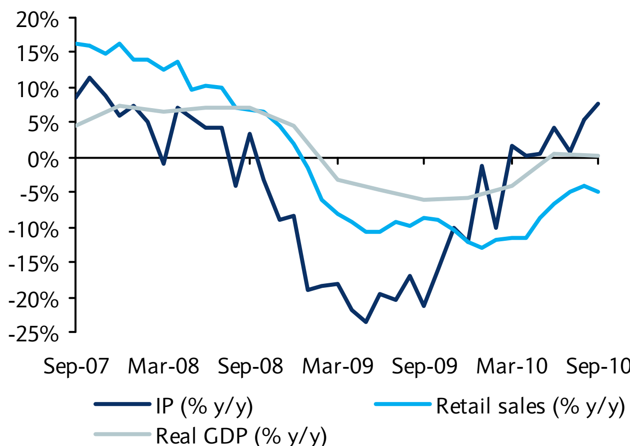
With domestic demand remaining subdued, Bulgaria's recovery has been driven by exports thus far. Growth could be marginally positive in 2010. The current account deficit has continued to narrow and remains fully financed by FDI. The fiscal deficit has continued to widen, but the government seems committed to address the issues. Government debt levels remain among the lowest in Europe. The resumption of FX reserve accumulation signals that the currency board arrangement remains well anchored.

Strategy: In our previous *Emerging Markets Quarterly*, September 2010, we argued that Bulgaria's vulnerabilities regarding its fiscal, banking sector and currency peg position are receding, and we recommended selling 5y Bulgaria CDS versus the CEEMEA SovX index. Having taken profits on the trade recently, we now see Bulgaria's improved fundamental outlook broadly reflected in current spreads. Bulgaria seems to be in a stronger position than many of its regional peers (Hungary and Croatia in particular), and while we prefer to stay on the sidelines for now, we would see any potential indiscriminate spread widening in the region as an opportunity for a renewed long credit/short CDS position.

Exports drive growth

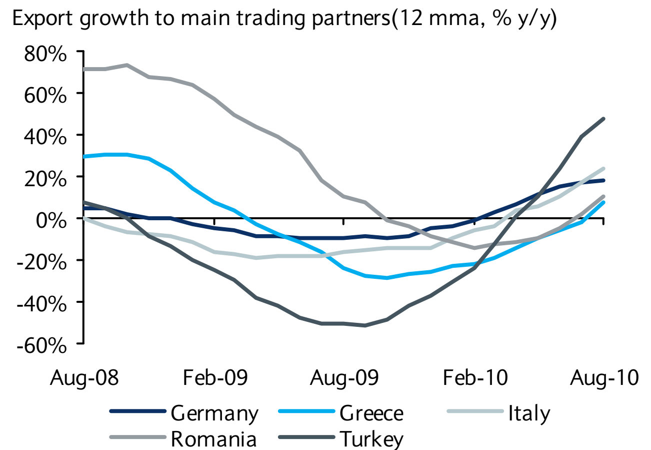
GDP displayed mildly positive growth for a second consecutive quarter: 0.5% y/y in Q2 was followed by 0.2% y/y in Q3. Industrial production seems to be on a firm recovery path, while retail sales are still declining and credit growth remains extremely weak. Consequently, domestic demand remains subdued and the recovery has been driven primarily by net exports (Bulgaria's goods exports constitute about 34% of GDP). Export growth has been driven mainly by booming exports to Turkey and Germany, which offset the weaker trade rebound with other traditionally large trading partners such as Greece and Romania. Another contribution to growth came from a relatively good summer tourist season (tourism accounts for about 8% of the economy). Overall, the above factors should help bring roughly flat growth for 2010, with some possible upside. We expect growth of 2.7% in 2011, supported by a broadening of the recovery in investment and consumption. It is also encouraging that official unemployment has been coming down gradually (8.9% in October), which compares favourable with other Balkan countries.

Figure 1: GDP growth slowly resuming



Source: Bulgaria National Statistics Institute, Haver Analytics , Barclays Capital

Figure 2: Exports to Turkey and Germany help recovery



Source: Haver Analytics, Barclays Capital

CA deficit has adjusted further, and FDI still fully covers deficit

As part of the export-driven growth, the current account deficit is expected to narrow further in 2010 to 3% of GDP. This is a massive adjustment from the pre-crisis deficit levels of more than 20% of GDP, and we expect only a moderate re-widening of the CA deficit in 2011-12. Importantly, FDI continues to more than cover the CA deficit. Since mid-2010, the capital account has started to exceed the CA deficit again on a 12-month rolling basis, allowing for increases in the Central Bank's gross reserves. These developments suggest the currency board arrangement continues to be well-supported.

Fiscal dynamics remain the main challenge

Cash versus accrual blunder from 2009 is being corrected in 2010

Ambitious 2011 budget

Turning around the fiscal dynamics remains the main challenge. The discovery of unpaid expenditure obligations after the new government took over last year turned a cash deficit of only 0.8% of GDP into an EU-definition deficit of 4.7% (as ESA 95 accounts on accrual basis). The government seems committed to turn this around, but in the absence of growth this is difficult. Lower-than-expected revenues due to slow growth and a number of one-off effects (such as VAT and excise tax refunds) have only been partially offset by expenditure compression. The government implemented measures, including raising the efficiency of tax collection, postponing pension increases and reducing public employment. Nevertheless, thus far the risk to the government's 4.6% cash deficit target seems on the upside, and we consider 5% of GDP as a more realistic number for 2010, which would leave the ESA95-defined deficit just above 4% of GDP.

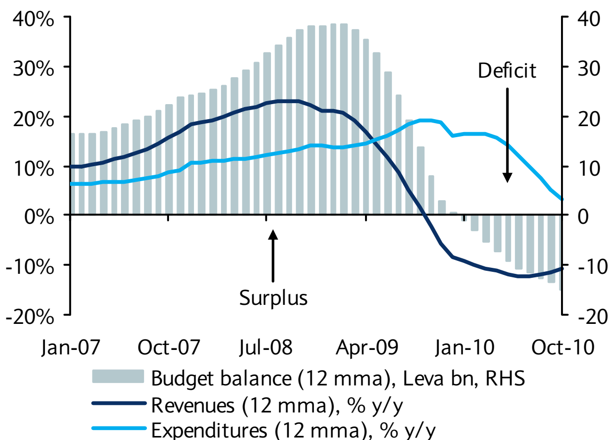
Financing likely to be obtained in domestic market, but external issue cannot be excluded

However, the commitment for further deficit reduction seems intact. The 2011 budget passed by parliament in November aims at a deficit reduction to 2.5% next year. While keeping personal and corporate income tax rates unchanged (at the lowest level among all EU countries), the budget incorporates increases in pension contributions and fuel excise taxes. Additional revenues are expected from further tax administration measures as well as from the economic recovery gaining pace. Increased absorption of EU funds is also expected as Bulgaria has made progress in fighting corruption. To finance the budget gap in 2011, the government expects to issue about USD1.4bn primarily on the domestic market, though it may also issue a Eurobond.

Currency board arrangement needs support from fiscal policy

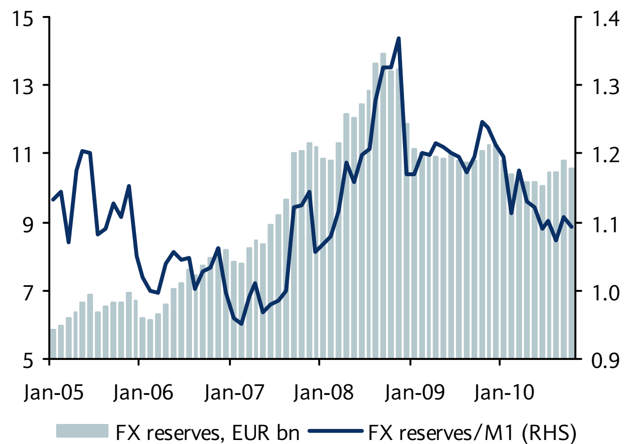
Given the currency board arrangement, Bulgaria's goal is to return to the fiscal surpluses it achieved in the pre-crisis years, enabling it to rebuild its fiscal reserve buffers to counter potential shocks. Fiscal reserves fell sharply during Q4 08 to Q2 10, halving to EUR3.1bn, but since then they have stabilised and increased slightly. Overall, fiscal dynamics looks

Figure 3: Fiscal developments have been worrisome in recent months



Source: Haver Analytics, Barclays Capital

Figure 4: Currency board remains well-supported



Source: Bulgaria National Bank, IMF, Haver Analytics , Barclays Capital

manageable once growth returns – even if at a much lower level than in the boom years. Although slowly rising, government debt levels still below 20% of GDP remain among the lowest in Europe.

Relatively mild inflation reduces competitiveness concerns

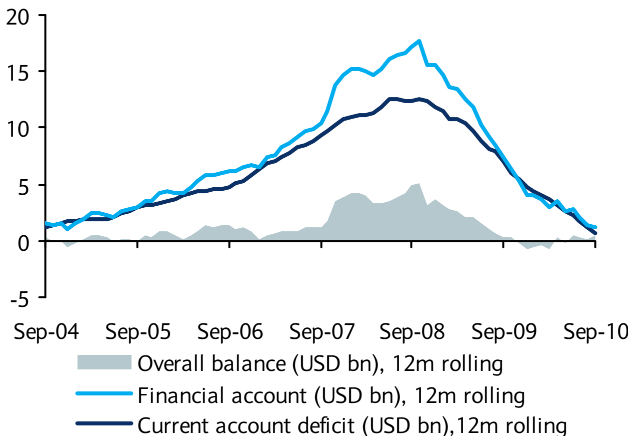
Inflation has been accelerating in recent months (printing 3.9% in October), driven mainly by rising food prices (food accounts for 35% of the CPI basket). Overall, the low inflation and modest wage developments have helped competitiveness under the fixed exchange rate regime, as also indicated by the robust growth in exports in the recent months. Despite the problems the euro area is facing, Bulgaria intends to resume its efforts to enter ERM 2 in 2011 to qualify for euro adoption (following the obligatory two-years in ERM 2). Similar to the Baltics, in our view, euro adoption remains a desirable strategy for Bulgaria's small open economy, which has shown a remarkable ability to adjust during the crisis and solid fiscal behaviour while operating under a currency board arrangement since 1997. Bulgaria's low GDP per capita – although not a Maastricht criteria – is clearly an obstacle in the eyes of the ECB, which wants to see more 'real convergence' before countries join the ERM 2 or the euro area.

Bulgaria's goal remains ERM 2, but the ECB seems reluctant

Banking system has remained relatively healthy thus far

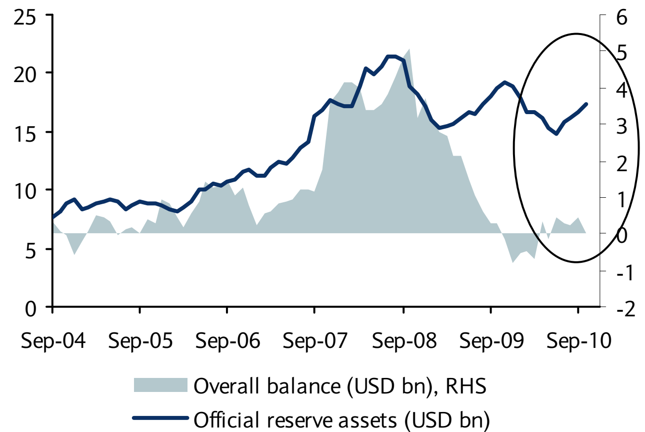
The banking system has weathered the crisis relatively well thus far. Though non-performing loans continue to increase, reaching 9.5% of total loans in June, they remain lower than in neighbouring countries such as Serbia and Romania. According to recent IMF assessments, local banks have sufficient capital adequacy ratios (18% in June) and profits to buffer potential losses. In light of the euro area periphery crisis, there have been concerns about Greek parent banks, which control about 30% of total bank assets in Bulgaria. In contrast to Hungary, Serbia and Romania, Bulgaria has no IMF-EU program that forced foreign banks to sign commitment letters (to maintain exposure to their affiliates) under the so-called Vienna initiative. However, disorderly withdrawal of Greek banks is not in their interest and, if certain parent banks plan to sell their affiliates, other foreign banks could be interested to step in.

Figure 5: CA adjusts and inflows exceed CA deficit again



Source: Haver Analytics, Barclays Capital

Figure 6: As a result, reserves are on the rise again



Source: Haver Analytics, Barclays Capital

Figure 7: Bulgaria macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.2	6.0	-5.0	0.2	2.7	4.0
GDP (USD bn)	40	50	47	49	53	58
Current account (USD bn)	-10.6	-12.1	-4.5	-1.5	-1.9	-2.1
CA (% GDP)	-26.8	-24.0	-9.4	-3.0	-3.5	-3.7
Gross external debt (USD bn)	40	54	52	53	56	58
International reserves (USD bn)	16.3	16.1	17.4	16.2	17.5	18.5
Public sector balance cash basis (% GDP)	3.5	3.0	-0.8	-5.0	-3.0	-2.0
Primary balance (% GDP)	4.6	3.9	0.0	-4.1	-2.0	-1.0
Gross public debt (% GDP)	17.2	13.7	14.7	18.5	20.5	21.0
General government balance (% GDP)	1.1	1.7	-4.7	-4.2	-3.3	-2.1
Prices						
CPI (% Dec/Dec)	11.6	7.2	1.6	4.5	5.0	5.2
EUR/Leva, eop	1.96	1.96	1.96	1.96	1.96	1.96

Source: Bulgaria National Statistics Institute, Bulgaria National Bank, IMF, Eurostat, Haver Analytics, Barclays Capital

EMEA: CÔTE D'IVOIRE

On the brink

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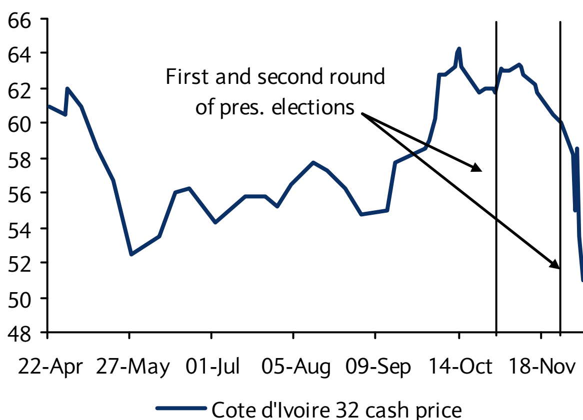
Côte d'Ivoire is in a period of acute political uncertainty with incumbent President Gbagbo unwilling to cede power after the electoral commission declared opposition leader Ouattara the winner of the presidential election. The crisis has deepened after both individuals were separately inaugurated as president of the country. Mediation efforts are underway but the situation remains tense and uncertain. Against this backdrop, we do not recommend holding positions in the Côte d'Ivoire 32 bond.

Strategy: The presidential election has darkened the outlook for the Côte d'Ivoire 32 bond. Incumbent president Gabgbo has held on to power, supported by the military, police and state media, while his rival Alassane Ouattara is recognised by the UN, EU, US, the African Union and ECOWAS as the elected president. As such, there is a high probability of serious political instability and, potentially, renewed and prolonged violent conflict, in our view. Prime Minister Soro and the ex-rebel Forces Nouvelles have pledged their allegiance to Ouattara, cementing the North-South division of the country. Ouattara has formed a new government with Soro (he resigned as Prime Minister in the Gbagbo government) as his prime minister and minister of defence. Strong international pressures and mediation efforts may still make some compromise possible, potentially involving the formation of a unity government, similar to the Ougadougou peace agreement in 2007. However, we expect the heightened tensions to persist for some time and potentially to worsen even further.

We do not recommend holding positions in the Côte d'Ivoire 32 bond given current uncertainties

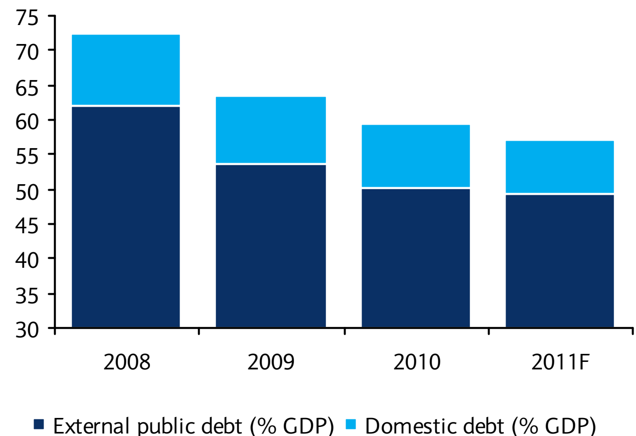
In an environment of continued division and violent conflict, the longer-term payment capacity for the Côte d'Ivoire 32 bond seems questionable. The IMF has already highlighted that it would not continue to work with a government that is not recognised by the UN, while the World Bank and African Development Bank also expressed their concern about the situation and indicated that they would reassess their lending programmes. Without the IMF and World Bank support, further debt relief under the HIPC programme, reforms to boost productivity in the cocoa sector and an increase in foreign investment, the economic outlook for Côte d'Ivoire looks challenging. Cash flows of the Côte d'Ivoire 32 bond are highly back-loaded. However, the willingness of a Gbagbo administration to continue

Figure 1: Political developments have caused the price of Côte d'Ivoire 32 bonds to decline sharply as risks increased



Source: Barclays Capital

Figure 2: HIPC debt relief unlikely to be granted if political crisis persists



Source: IMF

servicing external debt, while the international community does not recognise his government, also seems uncertain. Missed payments on the Côte d'Ivoire 32 bond would naturally lead to exclusion from benchmark indices and erode an important technical anchor. Against this uncertain outlook, we do not recommend holding positions in the Côte d'Ivoire 32 bond at this stage – even though a solution to the political impasse could open up significant upside potential, in our view.

What's next?

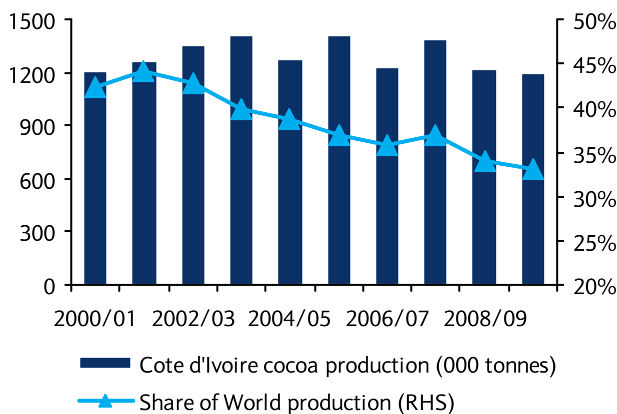
Political compromise possible, but damage in reunification process has been done

The African Union has called former South African President Thabo Mbeki to mediate in the crisis – Mbeki has mediated in the country before and is familiar with the country's political challenges. Mbeki, who mediated in Zimbabwe's crisis as well and was a key supporter of the power sharing accord there, may push for another such deal though it is unclear whether Ouattara will be in favour of such a resolution given that he has won the elections, according to the electoral commission and the UN. Meanwhile, some foreign media reports claim that Gbagbo has stated before that a power-sharing deal with Ouattara is out of the question. With two parallel governments running at the moment, there is a high risk that the situation may end up in more serious conflict with Gbagbo controlling the south of the country and the rebels still controlling the north. Should a situation arise where each of these two leaders governs his own territory, it will be a significant step back in recent efforts and progress to reunite the country and would undo much of what the 2007 peace deal was trying to achieve.

Political crisis is a setback to reforms in cocoa sector and ultimately to HIPC debt relief

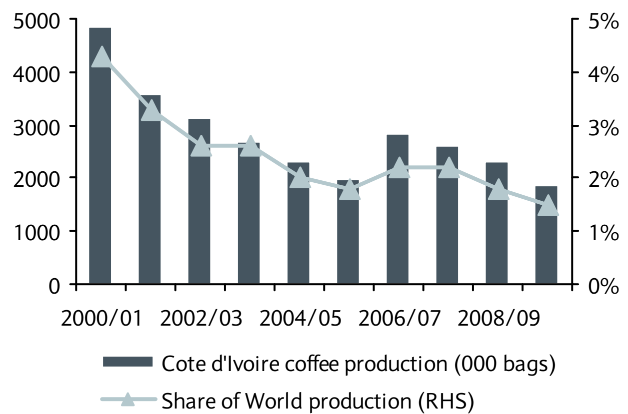
The economic consequences may also be severe as at least one large international mining company has already suspended operations due to the uncertain environment while the country may also face economic and political sanctions if the crisis is not resolved soon. The crisis will also drive the country's cocoa sector (which accounts for around one quarter of fiscal revenues) and other sectors such as coffee and mining into crisis – the country is the world's largest cocoa producer, contributing about one-third of total global output. The much needed reforms were considered the last major hurdle, other than the holding of peaceful elections, for reaching the HIPC completion point. The reforms, which involve changing the tax regime and the restructuring of the cocoa authorities and which will need to be in place for a period of six months before debt forgiveness comes into effect, may now be further delayed. The World Bank was to cancel USD3bn of Côte d'Ivoire's USD12.5bn in debt following the elections and after the cocoa sector reforms.

Figure 3: Cocoa reforms will be delayed further, which will have negative consequences for the sector and HIPC relief



Source: International Cocoa Organization, Barclays Capital.

Figure 4: The coffee sector is also likely to be impacted negatively by the crisis



Source: International Coffee Organization, Barclays Capital.

Figure 5: Selected macroeconomic forecasts

	2006	2007	2008	2009	2010E	2011F	2012F
Real GDP (% y/y)	0.7	1.6	2.3	3.8	3.0	4.0	4.5
CA (% GDP)	2.8	-0.7	1.9	7.3	6.8	2.5	0.1
FX reserves (USDbn, eop)	1.8	2.5	2.3	2.8	2.9	3.2	3.3
External debt (% GDP)	71.4	64.8	61.9	53.7	50.1	49.3	51.4
Overall fiscal balance (% GDP)	-1.8	-0.8	-0.6	-1.6	-0.2	-2.6	-3.2
CPI (% y/y, eop)	2	1.5	9	-1.7	2.1	2.5	2.5

Note: The forecasts are based on a scenario of a peaceful resolution to the current crisis. Source: IMF, Absa Capital

EMEA: CROATIA

A challenging year ahead

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Croatia continues to climb out of a prolonged recession, with the recovery remaining weak and unstable. Recent fiscal developments have not been favourable, and elections at the end of 2011 will pose an important test for the government that struggles to achieve the necessary expenditure consolidation. We expect growth to resume in 2011, but to achieve sustainable growth in the medium-term the government needs to implement structural reforms aimed at improving competitiveness. Completing the negotiations towards EU accession by mid-2011 would be a crucial step but is no panacea for the economy's issues.

Strategy: *We recommend buying Croatia 5y CDS versus Romania and switching from Croatia 19s, 20s into Lithuania 17s, 20s*

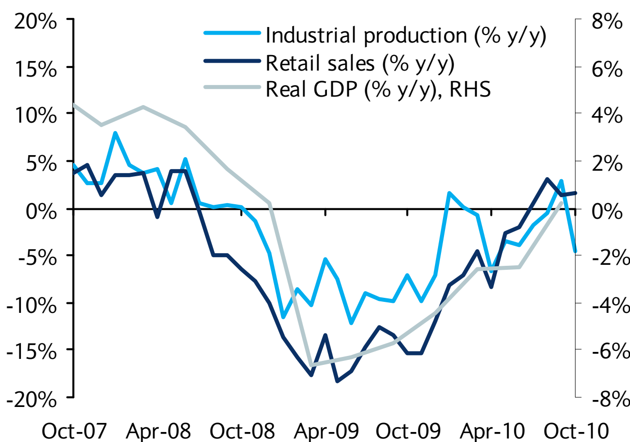
Strategy: We had a constructive stance on Croatia credit earlier in the year. However, the disappointing pace of growth recovery has brought to the fore the deeper structural challenges, and the significant fiscal slippage in the face of weaker-than-expected revenues has made us more cautious (see the *Emerging Markets Quarterly*, September 2010). With growth remaining subdued, exacerbated by the low competitiveness under the de-facto currency peg, we see the risks increasing further into 2011. Although fiscal responsibility legislation has been passed, the elections in 2011 provide an uncertain backdrop for much-needed expenditure consolidation. Hence, we take a cautious stance on Croatia credit at current spreads and express our cautious view via a long Croatia 5y CDS versus short Romania 5y CDS pair trade. Given Croatia's increasingly difficult outlook and Romania's improved performance under the IMF programme, we think the spread premium of Romania over Croatia is unjustified and look for the two countries' CDS spreads to re-converge. In cash, we recommend switching from Croatia 19s, 20s into Lithuania 17s, 20s.

Q3 GDP growth is positive due to tourism, but the country will still end 2010 in recession

Despite mildly positive Q3 GDP growth (after six consecutive quarters of declines) of 0.2% y/y, which was driven primarily by tourism activity, we see Croatia's economy contracting this year. As shown by high frequency indicators, the gradual recovery in domestic demand remains weak and unstable thus far. As the favourable effects from the summer tourist season dissipate in Q4, we expect economic activity to slow again, contributing to the negative growth rate of 1.8% for 2010 as a whole. External demand may help, but even robust goods exports performance has only a limited effect on GDP growth as exports' ratio to GDP is small (Figure 2). As for 2011, we expect positive growth of up to 1.8%, driven by consumption and investment recovery gaining pace.

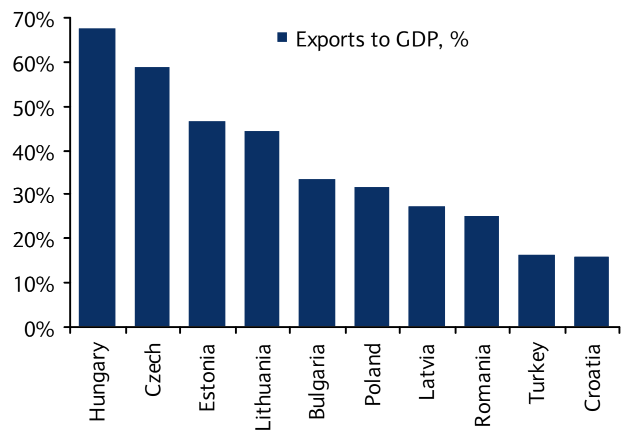
Growth to resume in 2011

Figure 1: Recovery is subdued and unstable



Source: Haver Analytics , Barclays Capital

Figure 2: Benefits from global trade recovery are limited



Source: Haver Analytics , Barclays Capital

Budget deficit likely to be higher than expected

Fiscal developments in Croatia over the past few months have been worrisome. As we noted in our previous EM Quarterly, the budget revision adopted in August that moved the 2010 deficit projection to 4.2% of GDP (from 2.5%) was based on an optimistic growth scenario. With recession having a larger-than-expected effect on tax collection, we believe this scenario is unlikely to materialize and expect the deficit to exceed 5.5% in 2010. Overall, however, Croatia's fiscal problems are more on the structural end on the expenditure side and thus will not disappear with the recession. To put the deficit on a declining path in the years to come, there is a pressing need to improve public sector efficiency (also through privatization) and targeting of social welfare benefits. For next year, the government intends to keep expenditures frozen and achieve a budget deficit of 4.3% of GDP. Potential risks include a slower-than-expected recovery and activation of shipyard guarantees. Even in the absence of an expenditure rise, we expect the deficit to widen (likely to 6%) in 2011 due to the withdrawal of solidarity tax and a drop in tax revenues caused by declining corporate profits in 2010. With parliamentary elections in November 2011, the proposed expenditure freeze will pose an important test for the government's credibility. In November this year, the government adopted the long-awaited fiscal responsibility law, but the extent to which it can provide an anchor for the much-needed expenditure consolidation remains unknown.

Expenditure consolidation will be a challenge in the election year

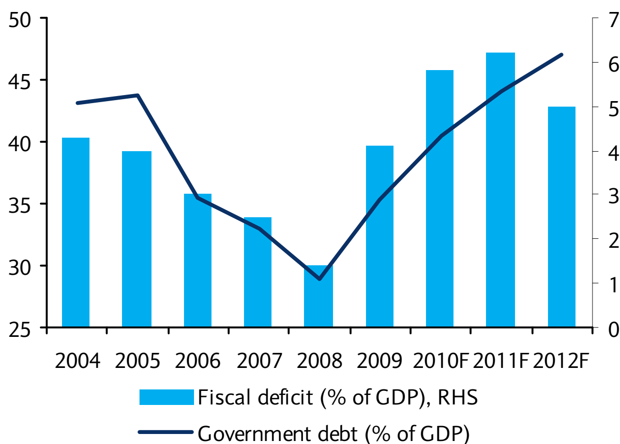
Public debt dynamics deserves monitoring

Continuous slippage in achieving budget deficit targets has put public debt dynamics on an unfavourable path. The issue is not yet alarming but undoubtedly deserves continuous monitoring. While public debt is likely to exceed 40% of GDP this year, together with state development bank arrears and the possible activation of state guarantees, it would exceed 55% of GDP. Since the issuance of a USD1.25bn Eurobond in June, the government has relied on obtaining financing on the domestic bond market. In October it also agreed on a syndicated loan of USD1.0bn with eight local banks. According to the budget, USD3.8bn bonds are expected to be issued in 2011 (of which about USD2.4bn - on foreign capital markets). Privatization receipts could be another source of financing. However, to fight the rising public debt ratio Croatia needs both fiscal consolidation and healthy growth which could be achieved only by implementing crucial structural reforms.

Banking system looks healthy enough thus far

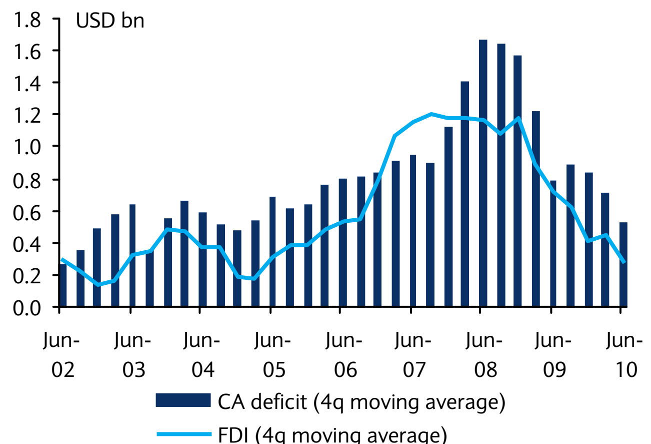
Weak economic performance weighs on the banking system, where nonperforming loans rose to 10% in September (from 9% in March). However, the system's reported average capital ratio of 19% seems satisfactory and is higher than in many other CEE region countries. High share of FX deposits and dependence on foreign funding remain risks in principle, but overall the banking sector looks relatively resilient thus far.

Figure 3: Budget deficit is widening, and public debt dynamics deserves monitoring



Source: Haver Analytics, Barclays Capital

Figure 4: Current account has adjusted, while FDI has fallen



Source: Haver Analytics , Barclays Capital

Inflation remains mild

CA deficit reduced, but FDI slumped in Q2

Reforms needed to enhance competitiveness and business environment

On the back of weak domestic demand and unemployment close to 18%, inflation remains mild, at 1.4% y/y in October (while core inflation has been close to zero since April). We see it picking up to about 1.5% by end-2010, partly due to a low base effect, and probably reaching 2.7% in 2011. Regarding external balances, imports remained subdued, which together with the 16% year-to-date gain in exports is likely to contribute to a significant reduction in the current account deficit to about 3% in 2010. On the financing side, Q2 was characterized by a sharp decrease in FDI, which more than offset the slight y/y improvement in Q1. The prolonged recession and fiscal problems are likely the main reasons behind this significant deterioration in investor sentiment. Negative GDP growth in 2010 will also contribute to a rise in the external debt ratio, which is expected to exceed 100% of GDP. However, the fact that about 30% of the external debt is extended by foreign parent banks and companies reduces refinancing risks. In addition, FX reserves cover more than 20% of GDP. As the recession recedes and EU accession negotiations get closer to an end in 2011, we also expect an increase in FDI (though to nowhere near pre-crisis levels) and external indebtedness. However, the sharp fall in FDI in Q2 may also be associated with government's inability to implement the structural reforms. With a stable exchange rate policy in place, this includes addressing the competitiveness issues through enhancing labour market flexibility: Croatia has high labour costs compared with some of its main export competitors (Bulgaria and Romania). Another area for potential reform is to increase private sector participation in the economy by improving business conditions. In the WEF Global Competitiveness Index and World Bank Ease of Doing Business Index, Croatia occupies 77th and 84th place, respectively, in both cases only above Serbia and Bosnia in the CEE region.

EU accession talks on track, but some obstacles remain

No-confidence motion shows government's unpopularity ahead of end-2011 elections

Negotiations towards EU accession will be crucial for Croatia in 2011. While important progress has been made this year, there is still a lot to be done in terms of competition policy, judicial system improvement and corruption. With 24 of 33 chapters already closed, the country hopes to finish negotiations in mid-2011, which should allow it to become an EU member in 2012. Hungary has recently emphasized that completing Croatia's negotiations with the bloc would be among the priorities during its EU presidency that starts in January 2011. While not specifying the exact date for completing talks, a recent EU annual report on candidate countries was encouraging for Croatia. In October, the government solved the last substantial bilateral problem with Slovenia (concerning savings of Croatians in a Slovenian bank and the access of the latter to the Croatian market), which until now blocked the country's bid to the EU. In November, Croatia received the bids (now submitted to the European Commission for revision) for the last of its five loss-making shipyards that need restructuring to comply with EU competition policy. The government also demonstrated its willingness to fight corruption even at the expense of undermining its own political positions. Following a number of high-profile corruption cases (including a prison sentence for the former deputy prime minister from the ruling Croatian Democratic Union), the government survived a no-confidence motion at the end of October. It was filed by the opposition party of Social Democrats who also took occasion to blame their opponents for the slow economic recovery. While the ruling coalition enjoys a healthy majority in parliament (80 seats out of 153), making the government's resignation unlikely, the situation clearly demonstrates its mounting unpopularity. Ahead of the end-2011 elections, this could make achieving the desired fiscal consolidation even more challenging.

Figure 5: Croatia macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	5.5	2.4	-5.8	-1.8	1.8	2.6
Domestic demand contribution (pp)	6.3	2.9	-6.0	-4.0	3.2	3.0
Private consumption (% y/y)	6.1	0.8	-8.4	-1.6	2.2	3.2
Fixed capital investment (% y/y)	9.0	9.0	-14.6	-11.7	8.8	1.8
Net exports contribution (pp)	-1.0	-0.3	-0.2	6.0	-1.1	-0.6
Exports (% y/y)	4.3	1.7	-16.2	3.3	1.7	0.9
Imports (% y/y)	6.5	3.6	-20.7	-1.9	3.8	2.0
GDP (USD bn)	59	69	63	61	62	66
External sector						
Current account (USD bn)	-4.4	-6.3	-3.2	-1.8	-2.5	-3.6
CA (% GDP)	-7.6	-9.3	-5.6	-3.0	-4.0	-5.5
Trade balance (USD bn)	-12.9	-15.9	-10.3	-7.8	-9.0	-11.5
Net FDI (USD bn)	4.7	4.7	1.6	1.1	2.0	3.0
Gross external debt (USD bn)	45	57	60	61	63	68
International reserves (USD bn)	13.7	13.0	14.4	15.0	15.5	16.0
Public sector						
Public sector balance (% GDP)	-1.6	-1.4	-3.9	-5.8	-6.2	-5.0
Primary balance (% GDP)	0.4	0.1	-2.5	-3.4	-3.5	-2.2
Gross public debt (% GDP)	37.7	33.5	35.0	40.5	44.0	47.0
Prices						
CPI (% Dec/Dec)	5.8	2.9	1.9	1.5	2.7	3.0
EUR/Kuna, eop	7.34	7.22	7.34	7.27	7.27	7.27
	1y ago	**Last**	**Q4 10F**	**Q1 11F**	**Q2 11F**	**Q3 11F**
Real GDP (y/y)	-5.7	0.2	-2.7	-1.2	1.4	2.9
CPI (% y/y, eop)	1.3	1.4	1.5	1.9	2.2	2.5
Exchange rate	7.32	7.42	7.27	7.27	7.27	7.27
CNB policy rate (%, eop)	6.00	6.00	6.00	6.00	6.00	6.00

Source: Barclays Capital

EMEA: CZECH REPUBLIC

Running on a full tank

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Strategy:
FX – Long CZK calendar call-spread

The Czech economy has grown more quickly than anticipated. This has not fed into inflation yet due to excess capacity. We think the upward growth momentum will continue in 2011 and the CNB will have to adjust its accommodative policy rate upward in the first half of 2011. In contrast, the CNB expects a double dip and therefore no rate changes until the later part of 2011.

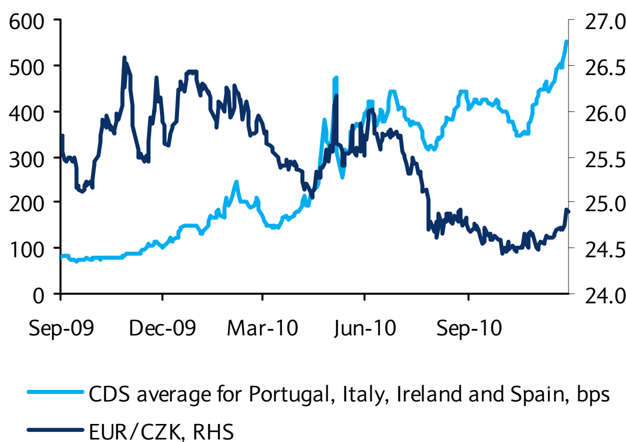
Strategy: We recommend being long CZK. Likely above-consensus growth in 2011 will result in continuing strong FDI and support monetary policy normalisation, both of which are FX positive. Sentiment towards CE FX seems to have been negatively affected by peripheral European market problems, but the contagion channels to the Czech economy are weak. There is little foreign positioning in local markets to be dislodged and the Czech banking system is generally fully financed with a 77% loan-to-deposit ratio. In the absence of a major write-down of German growth (not our baseline scenario), the Czech economic outlook should be solid (Figure 1). Sentiment towards CE FX will likely slowly differentiate, hence we recommend using the low (by historical averages) levels on implied volatility to position long CZK through a calendar-call spread. We recommend buying a 5m CZK call (EUR put) with 24.50 strikes and selling a 2M CZK call with the same strike at a combined cost of 55bps. The risk to the trade is a scenario of a sharp CZK rebound in 2m and then trend depreciation, but the probability of this seems low given the fundamental drivers. For cash investors, dip buying CZK around current levels also makes sense, in our view. Paying rates is also consistent with our view, although the tightening of monetary conditions in the Czech Republic tends to be a process where even though the first step is a hike, the overall burden of adjustment is mainly on FX.

Growth gaining momentum

Czech growth has been accelerating in 2010 based on strong production and investment

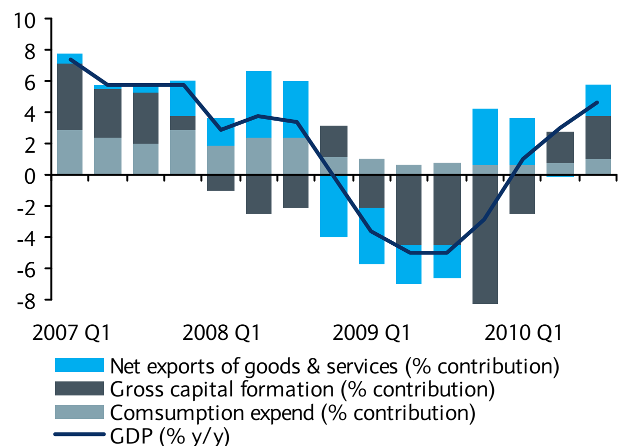
Growth has surprised to the upside in 2010 and seems to be gaining momentum (Figure 2). The main element has been a surge in investment as Czech production appears to be gaining based on monthly data. PMI has been in expansionary territory for some time and is the highest in the region. Industrial production is rising led by expansion of intermediate and

Figure 1: CZK cannot be shielded from contagion but the impact should not be lasting



Source: Bloomberg

Figure 2: Czech growth has surprised to the upside



Source: Czech Statistics Office, Haver Analytics

capital goods. New orders are increasing led by computers, electronics, and machinery. The recovery in production is starting to feed through to consumption as employment has been increasing and wages are rising; retail trade has shown some signs of coming back. There has been some pick-up in lending to both households and businesses.

We predict steady growth in 2011-12 in contrast to the CNB forecast of a double dip

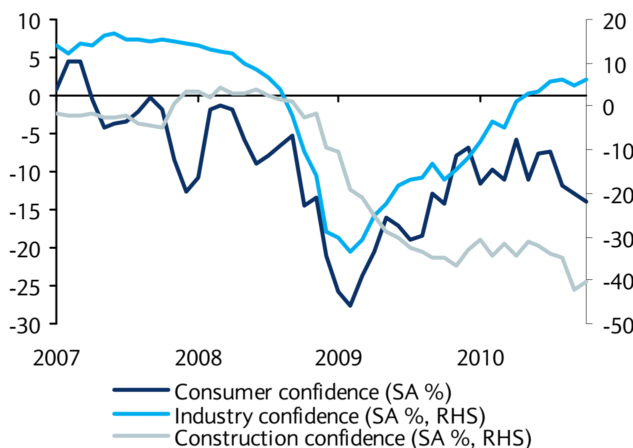
We predict that growth will continue to accelerate in 2010, reaching 2.5% y/y, higher than the CNB forecast of 2.3% (up from its previous forecast of 1.6% and our prior estimate of 2.2%). For 2011 we expect acceleration in growth to 3.3% compared with the CNB forecast of 1.2%, and we forecast growth of 3.4% y/y in 2012 versus 2.5% for the CNB. The CNB continues to predict a double dip in growth based primarily on a slowdown in external demand from Europe, combined with the cutback in government spending leading to deceleration in private consumption and investment, The Ministry of Finance is considerably less pessimistic, looking for flat growth in 2011. Given the 4% q/q growth in Q2 and Q3, we consider our forecasts reasonable, allowing for some deceleration in growth due to fiscal adjustments. We believe the CNB is too pessimistic, based on our view that German growth will hold up in 2011. The Czech economy has been gaining momentum for a protracted period (ie, most of 2010) and is now able to generate some self-sustained domestic consumption in the economy. Barring a sharp downturn in German growth, confidence levels in the Czech private sector should hold up. Czech household consumption has been rising at a rate of nearly 4% in recent quarters and the indicators of strong consumer confidence should still be feeding through (Figure 3). Investment has started to recover from a very low level and while there may not be any great urgency to add to production capacity (there is still an output gap), the risks are probably to the upside now that confidence is turning.

Inflation remains tame

Headline inflation has been pushed up into the middle of the target range by higher food, energy and administrative prices

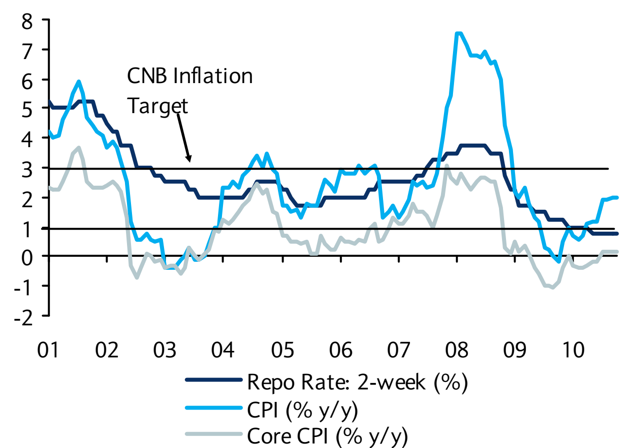
Headline inflation has been steady for the past four months at 1.9% y/y (Figure 4). This compares favourably with the CNB 1-3% inflation target. Moreover, domestic inflationary pressure is low; core inflation is up only 0.2% y/y and this is an improvement - previously core inflation was negative for a period of 14 months. The factors pushing inflation have been energy costs (+11.8% y/y), food and non-alcoholic beverages (+3.8% y/y), and goods with administered prices (+3.7%). Clearly, demand-pull inflation is minimal. However, given our optimistic view of growth in 2011-12, it could become an issue late next year.

Figure 3: Czech consumer confidence gaining



Source: Czech Statistics Office, Haver Analytics

Figure 4: Headline inflation is rising, but core inflation remains close to deflationary levels



Source: Czech Statistics Office, Haver Analytics

Monetary policy outlook – when will the CNB raise rates?

The CNB policy rate is extremely low at 0.75% and we expect rate hikes in H1 11, the CNB predicts rate hikes only towards the end of 2011

The CNB is maintaining accommodative monetary policy with the policy rate held at 0.75%, leaving real rates highly negative, both currently and prospectively. The CNB has reason to remain dovish given its macroeconomic forecasts. As indicated above, its foresees growth to be on the verge of moderating sharply next year due to a double-dip in the euro area economies and an expected decline in domestic demand. Furthermore, monetary policy relevant inflation is below 1% y/y. On this basis, the CNB does not expect to raise rates until the last quarter of 2011. We foresee the rate hike cycle beginning in the first half of 2011 based on continued strong growth.

Current account deficit trending up

The current account is weakening, although financing remains robust

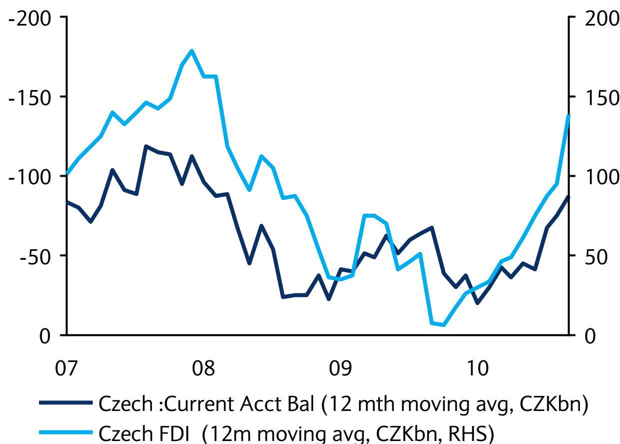
The current account deficit narrowed to 1% of GDP in 2009 but re-widened, again, to an estimated 3.3% this year (Figure 5). The deficit widened considerably in Q3 10 as the balance of services and income declined and the trade deficit started to widen. We see the widening as further indication that the economy is picking up. We do not view it as a source of concern for the markets, as FDI has also recovered (partly due to reinvested earnings and is therefore an 'accounting item') and there is evidence that some of this is new investment as well. This is corroborated by the pickup in investment spending in the economy and further reserve accumulation by the CNB.

Fiscal strength

Rating upgrades likely as Czech Republic rapidly lowers its fiscal deficits

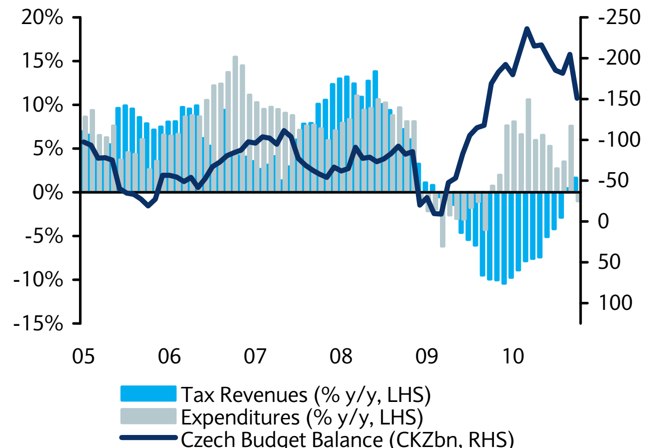
The widening of the fiscal deficit was one of the primary issues in the parliamentary elections that took place in 2010; the fiscal conservatives won a resounding victory. The deficit in 2010 is targeted to decline to 5.3% of GDP from 5.8% in 2009. However, the performance has been better than expected in 2010, partly because of lower-than-budgeted expenditures (Figure 6). For the 2011 budget, the new government is implementing a new set of measures to bring the deficit down to 4.6% of GDP. Most notably, these include tax increases (mainly social security contributions and PIT, leading to a CZK20bn/0.3% GDP of additional revenue) and expenditure cuts (CZK59bn/1.0% GDP). On the latter, the key cuts are in public sector wages and social security benefits as well as general current spending items. We expect the deficit to be reduced to 3% of GDP in two years' time. The Czech government debt levels are low at around 35% of GDP. The Czech Republic's sovereign

Figure 5: Current account is deteriorating, but remains very well financed



Source: Czech Statistics Office, Haver Analytics

Figure 6: Fiscal deficit declining solidly



Source: Ministry of Finance, Haver Analytics

rating will likely be upgraded if it achieves its plan; both Standard & Poor's and Fitch have positive outlooks. The growth implications of fiscal tightening can only be negative. However, the nature of the adjustment contrasts with what we have seen in neighbouring countries (where the emphasis has been on burdening the corporate sector with more taxes). This makes us confident in arguing that this type of fiscal tightening should leave business confidence broadly unaffected.

Figure 7: Czech Republic macroeconomic forecasts

Czech	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.1	2.5	-4.1	2.5	3.3	3.4
Domestic Demand Contribution (pp)	5.2	1.0	-3.5	2.3	3.5	3.4
Private Consumption (% y/y)	4.8	3.6	-0.3	1.8	3.3	3.2
Fixed Capital Investment (% y/y)	10.8	-1.5	-8.3	-3.7	8.5	8.2
Net Exports Contribution (pp)	0.9	1.3	-0.7	0.3	-0.2	0.0
Exports (% y/y)	15.0	6.0	-10.2	11.7	10.8	10.5
Imports (% y/y)	14.3	4.7	-10.2	10.4	8.0	8.1
GDP (USD bn)	175	217	192	225	242	256
External Sector						
Current Account (USD bn)	-5.6	-6.6	-2.0	-5.8	-8.1	-8.9
CA (% GDP)	-3.2	-3.1	-1.1	-2.6	-3.3	-3.5
Trade Balance (USD bn)	5.9	6.4	10.4	10.6	11.1	11.1
Net FDI (USD bn)	9.4	8.5	1.4	7.9	9.9	9.9
Other Net Inflows (USD bn)	-2.6	0.0	1.0	1.3	1.5	1.8
Gross External Debt (USD bn)	76	80	81	82	83	84
International Reserves (USD bn)	35	37	42	47	53	57
Public Sector						
Public Sector Balance (% GDP)	-0.7	-2.7	-5.8	-5.3	-4.6	-3.8
Primary Balance (% GDP)	0.5	-0.3	-4.1	-3.8	-3.3	-2.7
Gross Public Debt (% GDP)	28.3	25.8	30.7	34.6	36.4	37.3
Prices						
CPI (% Dec/Dec)	5.5	3.6	1.0	2.1	2.2	2.0
EUR/CZK, eop	26.6	26.9	26.5	25.0	23.9	23.0
	1yr Ago	**Last**	**10Q4F**	**11Q1F**	**11Q2F**	**11Q3F**
Real GDP (y/y)	-5.0	3.0	3.0	5.4	5.2	3.5
CPI (% y/y, eop)	1.0	2.0	2.1	2.0	1.9	2.2
Exchange Rate (eop)	26.47	24.61	25.0	25.0	24.2	23.9
CNB policy rate (%, eop)	1.00	0.75	0.75	1.00	1.50	2.00
Market implied rate (%, eop)			0.50	0.75	0.75	1.00

Source: Czech National Bank, Ministry of Finance, Czech Statistical Office, Haver Analytics, Barclays Capital

EMEA: EGYPT

Leaning on the fiscal

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Parliamentary elections confirmed the NDP's firm control of the People's Assembly. As it eyes next year's presidential elections, the government is likely to loosen its fiscal stance further, partly in response to rising social demands, against the backdrop of softening growth and continued commodity price pressures. We believe there is little room for further nominal EGP appreciation over the next year and expect sovereign credit spreads to underperform.

Strategy: *We see EGP weakening, and recommend switching into Qatar & Qatari Diar 20s from Egypt 20s*

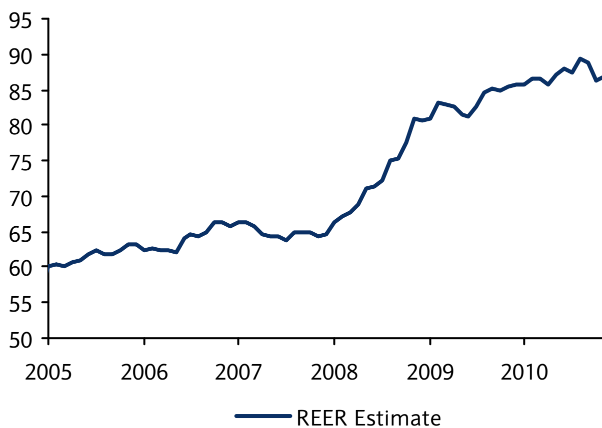
Strategy: Based on Egypt's moderating macro outlook, expectations of further fiscal loosening, and its expensive currency on a real effective exchange rate basis (Figure 1), we believe there is little room for much more nominal EGP appreciation. While we still believe that the CBE will focus on EGP stability, the bias will likely be towards modest bouts of depreciation to protect against further erosion in competitiveness. However, any weakening of the EGP will be limited, we think, as core inflation approaches the upper end of CBE's comfort range and potential inflationary pressures persist on the back of commodity price increases, and stronger domestic demand fuelled by higher public spending. Consequently, we revise our EGP forecasts weaker to reach 5.82 in 3 months. On the credit side, Egypt has outperformed global EM credit over the past few weeks. The regional support base resulted in a comparatively low correlation to global risk drivers and, with UST yields increasing and bond prices slow to adjust, spreads have continued to tighten. This leaves little room for further upside, in our view. In light of the political and fiscal risks, we remain cautious on Egypt credit and recommend selling Egypt 20s, switching into stronger credits in the MENA region, such as Qatar. In order to pick up spread, we recommend switching into the government-guaranteed Qatari Diar 20s and expect the recent underperformance of the Qatari Diar 20s versus the Egypt 20s to reverse (Figure 2).

The NDP won the majority of seats

The opposition reported irregularities and withdrew from the runoffs

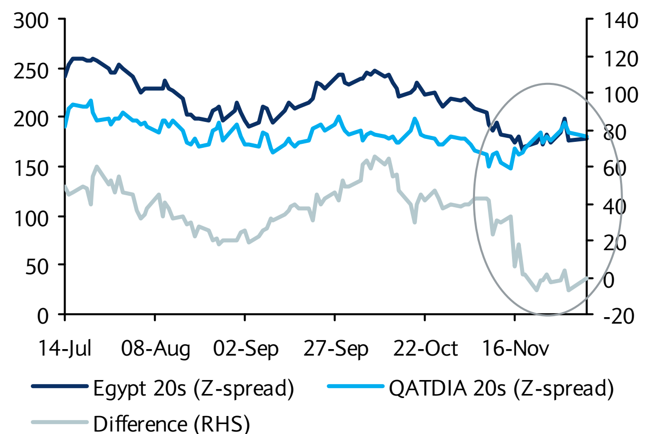
As expected, the two rounds of Parliamentary elections, confirmed a sweeping victory for the ruling National Democratic Party (NDP), but on the back of heightened political tension and discontent. Out of a 518 seats in total, 508 seats were contested (64 of which were reserved for women) and 10 appointed by the president. With a low turnout (35% and 27% in the first and second round, respectively), the NDP won 420 seats, according to Egyptian elections commission, while 69 went to independents and 15 to opposition parties. In

Figure 1: EGP still looks relatively expensive on a REER basis



Source: CBE, Bloomberg, Barclays Capital

Figure 2: Egypt 20s look expensive versus QATDIA 20s



Source: Bloomberg, Barclays Capital

contrast, the Muslim Brotherhood, did not win a single seat and withdrew from the runoffs, after it had gained 88 during the 2005 elections. With international monitoring of elections disallowed, local and international media and think tanks[2] have reported several irregularities, including fraud, forgery, ballot box stuffing and coercion. Opposition parties called for the cancellation of the elections, and several countries, including the US, through its State Department, expressed dismay regarding interference from security forces and intimidation of voters and candidates.

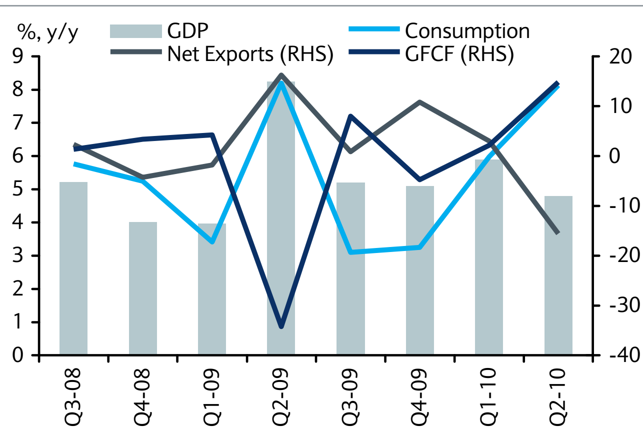
Attention turns to the presidential elections

With the NDP firmly in control of the Assembly, attention is now turning to the presidential election in September 2011, amid a highly charged political environment. At present, no opposition candidate is likely to run against the NDP presidential candidate, and the identity of the latter is still unclear. While a senior NDP official hinted that President Hosni Mubarak could seek a sixth term in office (BBC News, Middle East, 21 October 2010), no formal announcement has been made yet, as it will depend primarily on the health of the outgoing President. Also, even though publicly available data suggest the President's son, Gamal Mubarak, could be the successor, his appointment would be breaking with the historical tradition of appointing a president with previous military experience *(*see *Egypt trip notes: Succession politics – more risk but still ample reward,* April 2010). Whether the NDP chooses to nominate Gamal Murbarak or may consider other candidates from the military remains to be seen. Under any of these scenarios, we would expect the NDP to stay focused on promoting greater acceptance of its candidate, implying higher fiscal outlays in 2010/11 and throughout 2011/12, we believe. The announcement of an imminent cabinet reshuffling is a first step in that direction.

Q2 10 GDP growth has softened

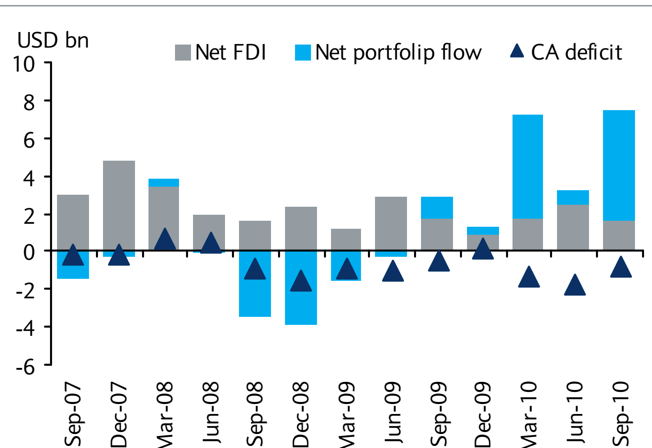
The renewed NDP mandate comes against mounting challenges on the economic front. First, we are seeing a softening of growth drivers. The robust domestic demand notwithstanding, Q2 GDP surprised on the down side, retreating to 5.4% y/y from 5.7% y/y in Q1 10 driven by a sharp decline in net exports. With the US and Europe accounting for 30% of Egypt's export markets, the external demand outlook is still complicated in light of rising peripheral European debt woes, and the implications of fiscal adjustment efforts on growth in developed countries. Improvements in non-hydrocarbon exports and strong consumption notwithstanding, growth of net export and private investment is still a laggard (Figure 3).

Figure 3: Growth is softening as external demand weakens



Source: Central Bank of Egypt, Have Analytics, Barclays Capital

Figure 4: and CA deficits are larger than last year while capital inflows are more volatile



Source: Central Bank of Egypt, Have Analytics, Barclays Capital

[2] These include BBC news, *Almasryalyoum* newspaper, Al Jazeera, Carnegie Endowment for International Peace.

… and current accounts are widening further

Second, weakness in external demand translated into current account deficits for two consecutive quarters (Q2 and Q3), which widened further compared with their levels in FY 2009/10 on the back of strengthening domestic demand, flatter gas prices, higher commodities prices and a subdued external demand outlook (Figure 4). We thus revised downward our growth forecasts for Q3 and Q4 2010 to 5.3 and 5.6% y/y respectively, and our overall growth for 2010/11 to 5.7%, down from 6.2% y/y. We think that until September 2011, growth is likely to benefit from continued government stimuli, ie, through higher public investments and additional spending on subsidies and wages, which should help to maintain higher consumption, albeit at a more moderate pace given high inflation levels. This should drive the current account slightly wider to 2.6% of GDP in FY 2010/11 up from 1.52% a year earlier.

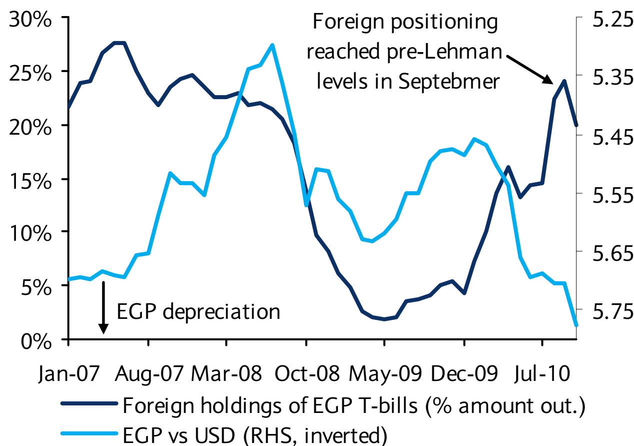
FDI flows are lagging and portfolio flows are volatile

While FDI flows (historically the most significant component for capital inflows) remain lower than pre-crisis levels, the financing of the deficit is not a major concern in the short-term in our view, as continued portfolio inflows should be enough to bridge any shortfall. However, risks to the financing outlook have increased relative to the past 12 months, we think. Future foreign bids for EGP paper are likely to be more volatile, as inflows into local EM bond funds adjust to a more sustainable level, and without the more sticky support from FDI inflows, this volatility will likely feed into the financing of the CA (Figure 4). Accordingly, we think the CBE will be tracking foreign positioning closely in order to avoid a repeat of the sell-off seen in October. During this period, extreme EGP stability encouraged a build-up in foreign holdings of T-bills to pre-Lehman levels (Figure 5), contributing to higher volatility as these positions were subsequently unwound. The challenge for the CBE therefore will be to strike the right balance – enough volatility to cap excessive positioning, but not too much to endanger financing.

The CBE is closely watching inflation

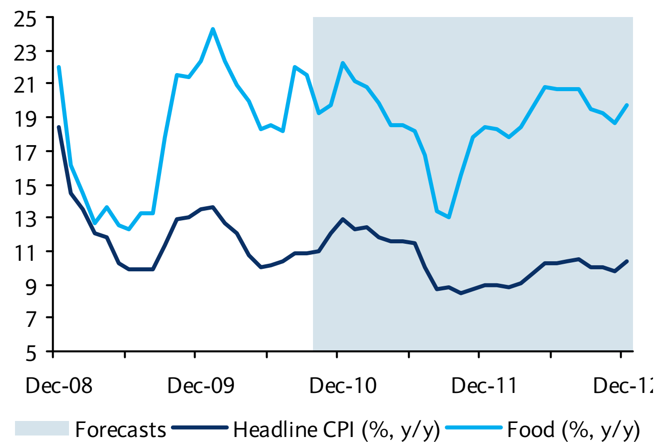
The CBE is also closely monitoring inflation drivers. Following a rapid decline from its December 2009 peak of 13.64% y/y to 10.1% y/y in June, the upward inflation trend over the past four months is largely attributable to supply factors as reported by the CBE. The majority of the recent spike in international commodity prices has been absorbed by the budget through higher subsidies, in order to ensure stable bread and energy prices. We expect this to continue into 2011, and inflation to gradually abate after the large base effects we anticipate in November and December 2010. However, rising public spending, by fuelling higher consumption, will likely limit any inflation decline in H2 2010/11 (Figure 6). Until then, and with growth still softer than expected, we think the CBE will maintain a steady monetary policy stance, keeping rates on hold until at least end of June 2011.

Figure 5: Foreign positioning in EGP T-bills reached pre-Lehman levels in September



Source: Central Bank of Egypt, Have Analytics, Barclays Capital

Figure 6: Inflation dynamics will keep the CBE on its toes



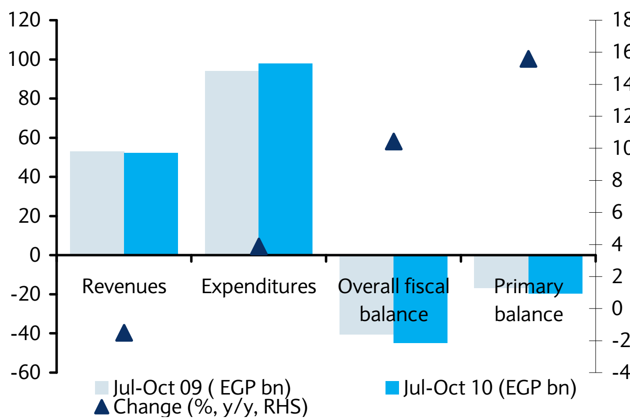
Source: Central Bank of Egypt, Barclays Capital

… and fiscal deficits are widening

Softening economic growth, heightened political tensions, and persistent pressures from global commodity prices are weighing on the fiscal accounts. On the one hand, the need to contain the rising cost of wheat led the government to recently pass an EGP3.5bn (USD615mn) budget supplement to meet rising food imports. This came close to our own estimate of USD700mn required to finance purchases at wheat price hovering USD300 per ton (see *MENA Monthly: Sailing through headwinds,* 13 September 2010), In fact, the General Authority for Supply Commodities (GASC) has been buying wheat at prices of USD270-313 per ton over the past three months compared with a budgeted price of USD200. In addition, the Minister of Finance signalled that the budgeted figures for the energy subsidy are likely to double, while the Minister of Solidarity declared that Egypt will spend an additional EGP32bn (USD5.65bn) on subsidies in 2010/11. These declarations were recently complemented by the government's announcement of a possible new fiscal stimulus package, which could be adopted towards the end of June in order to boost domestic demand, similar to what occurred early in the global downturn.

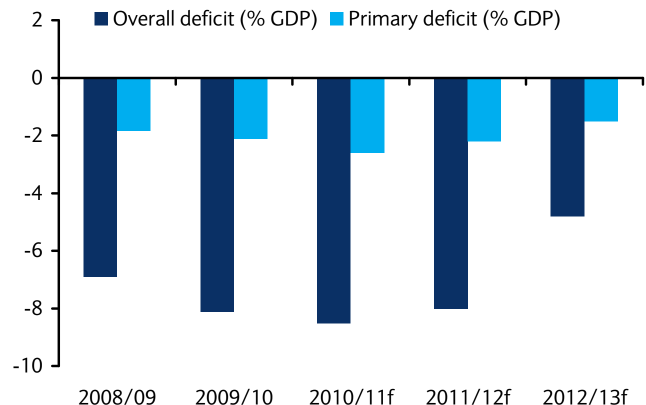
While we had been expecting further fiscal loosening above the budget plan, we think this stance does not augur well for medium-term fiscal sustainability, especially against the background of a challenged growth outlook. During the first four months of FY 10/11 (July-October 2010), the overall fiscal deficit increased by 10.4% y/y. Spending, driven by a 13.1% hike in wages and salaries, rose by 3.9% y/y; meanwhile, revenues declined by 1.5% y/y as the fall in grants, property income and non tax revenues outweighed the jump in tax revenue of 12.4% y/y. We expect this pattern of additional spending to prevail following the government reshuffle announced this week, particularly if the NDP continues with its succession plans supporting the candidacy of Gammal Mubarak. Under such a scenario, we would not rule out a possible deterioration in the FY 10/11 budget deficit beyond our original 8.5% of GDP (up from 8.2% last year), which could then bring debt-to-GDP to 80% up from 78.5% of GDP. Escalating political tensions during the year constitute a downside risk, notably if the Muslim Brotherhood were to stir social unrest to contest the election results. In such a case, we could see the government resorting to raising wages and subsidies further.

Figure 7: The FY 10/11 fiscal deficits are widening



Source: Central Bank of Egypt, Have Analytics, Barclays Capital

Figure 8: ….and are likely to remain big for a while



Source: Ministry of Finance, Have Analytics, Barclays Capital

Figure 9: Egypt macroeconomic forecasts

	2006/7	2007/8	2008/9	2009/10	2010/11F	2011/12F
Activity						
Real GDP (% y/y)	7.1	7.2	4.7	5.1	5.7	6.2
Domestic Demand Contribution (pp)	10.7	7.6	2.6	5.0	5.5	5.7
Private Consumption (% y/y)	8.8	5.7	5.7	5.5	5.7	5.9
Fixed Capital Investment (% y/y)	23.7	14.8	-10.2	4.0	5.0	3.2
Net Exports Contribution (pp)	-3.3	-0.5	2.1	0.1	0.1	0.6
Exports (% y/y)	20.2	28.8	-14.5	8.0	13.5	19.0
Imports (% y/y)	30.5	26.3	-17.9	6.0	12.0	16.0
GDP (USD bn)	130.5	162.9	188.4	217.3	247.7	274.4
External Sector						
Current Account (USD bn)	2.3	0.9	-4.4	-3.3	-6.5	-8.3
CA (% GDP)	1.7	0.5	-2.3	-1.53	-2.6	-3.0
Trade Balance (USD bn)	-16.3	-23.4	-25.2	-25.8	-28.9	-30.0
Net FDI (USD bn)	11.1	13.2	8.1	6.8	7.8	8.8
Other Net Inflows (USD bn)	-8.1	-2.2	5.1	-3.8	-2.7	-1.0
Gross External Debt (USD bn)	29.9	33.9	31.5	35.3	38.3	41.3
International Reserves (USD bn)	27.2	32.8	29.4	31.7	34.6	36.2
Public Sector						
Public Sector Balance (% GDP)	-7.5	-7.5	-7.0	-8.2	-8.5	-8.0
Primary Balance (% GDP)	-2.4	-3.0	-1.9	-2.2	-1.9	-2.2
Gross Public Debt (% GDP)	81.2	72.9	75.9	78.5	79.9	80.5
Prices						
CPI (% June/June)	8.6	20.2	9.9	10.1	11.5	10.3
FX, eop (june)	5.69	5.35	5.59	5.70	5.92	6.00
	1yr Ago	**Last**	**Q4 10F**	**Q1 11F**	**Q2 11F**	**Q3 11F**
Real GDP (y/y)	4.1	5.4	5.6	5.8	6.0	6.1
CPI (% y/y, eop)	13.5	11.0	13.0	11.9	11.5	8.8
Exchange Rate (eop)	5.58	5.65	5.80	5.82	5.92	5.94
Monetary Policy Benchmark Rate (%, eop)	8.25	8.25	8.25	8.25	8.50	8.50

Source: IMF, Haver Analytics, Egyptian Ministry of Finance, Central Bank of Egypt, Barclays Capital

EMEA: GHANA

Great expectations…limited oil revenues

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Ghana's future looks bright, with oil production set to start on 15 December 2010. However, initially, the direct impact of oil on fiscal revenues may be limited. The government's fiscal credibility will likely remain under pressure given its population's high expectations based on oil revenue.

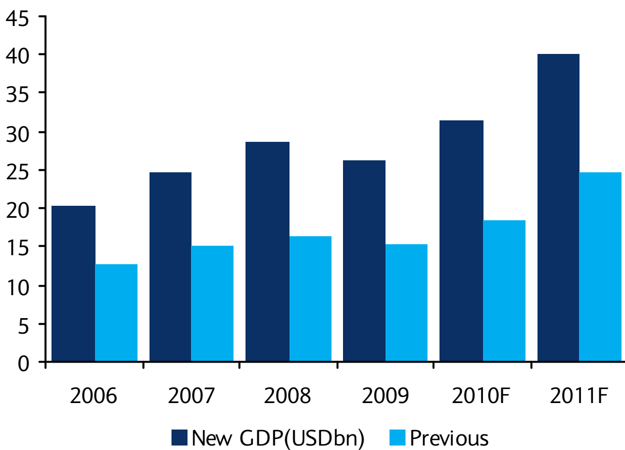
Strategy: Fiscal concerns and a potential new Eurobond issuance next year continue to weigh on the Ghana '17 bond. While Ghana '17 spreads have avoided the volatility seen in other parts of the EMEA region over the past couple of months, Ghana credit underperformed its regional Gabon peer. Given the continued fiscal pressures, a spread rally is unlikely at this stage, in our view. However, based on relative valuations in the region, we see decent value in the Ghana 17 bond at current levels. We highlight that a potential new Eurobond issue, while a concern for external debt valuations, would certainly be a positive for local debtholders. We expect any new Eurobond proceeds, together with likely oil revenues, to put some appreciation pressure on the Ghanaian Cedi over the coming months. Although the Central Bank of Ghana is likely to keep any substantive appreciation contained, this should add to the attractive carry of Ghanaian local bonds (3y bond yields are currently around 13% in the secondary market). We recommend building exposure via participation in upcoming primary auctions (3y bond) – Ghana continues to offer the most attractive local debt market opportunities in Sub-Saharan Africa, in our view.

Oil production to boost economic activity

Currency will be under pressure to appreciate

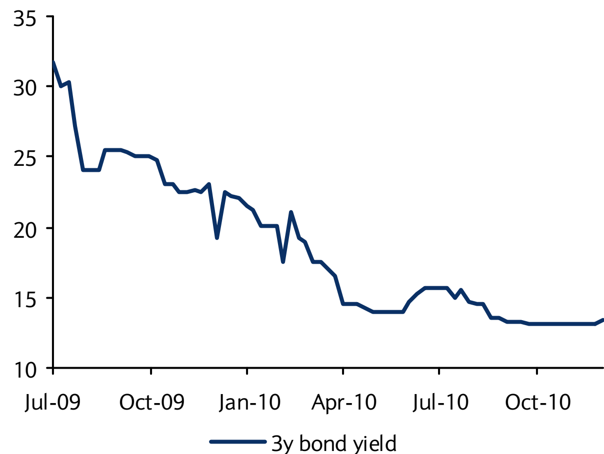
Ghana's statistical office, following revisions to national account data, indicated that growth is likely to be 6.6% in 2010 with the services and industrial sectors likely to grow by over 8% and 6%, respectively. The outlook for 2011 is significantly more upbeat as a result of oil production. Tullow Oil announced recently that oil production will commence on 15 December, with initial production at 50,000bpd, increasing to 120,000bpd within three to six months. Hence, in 2011, we expect oil production to push real GDP growth to around 13%. We anticipate oil export revenues of USD2.5-3.0bn in 2011, which will support the

Figure 1: Data revisions raised Ghana's nominal GDP



Source: GSS, Absa Capital

Figure 2: Despite decline, yield remains in double-digits



Source: Reuters, Absa Capital

currency and external accounts. These inflows, combined with that of the potential USD700mn Eurobond, continued multilateral support and private inflows, will put substantial pressure on the exchange rate to appreciate.

No further policy easing likely as inflation may have bottomed

The inflation environment remains positive, although we expect high public sector wage increases, anticipated higher food prices and utility price increases to put upward pressure on inflation later in 2011. As such, we expect inflation to edge higher from October's 9.4% y/y to around 11% by end of 2011. However, given the need to provide support to still-sluggish domestic demand, we expect the Bank of Ghana to maintain the policy rate at 13.5% until domestic demand improves before responding to higher inflation.

Managing expectations when oil revenues are still low

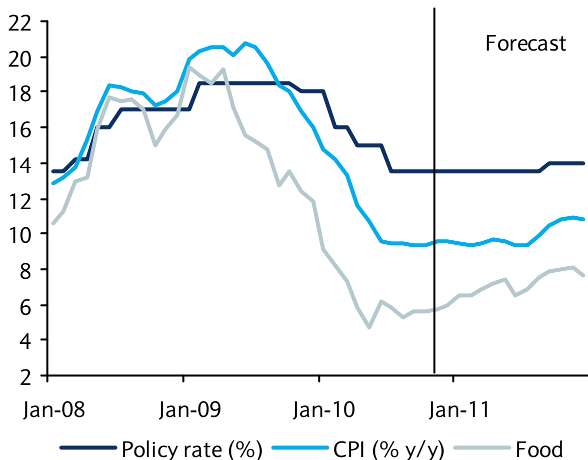
2011 Budget highlighted the limited oil revenues

Ghana's oil resources have resulted in its population having high expectations of a booming economy and a significant reduction in unemployment and poverty. As such, the government is already under pressure to expand social and other infrastructure. However, the 2011 Budget presentation read on 18 November showed that the government has limited resources as it is already struggling to reduce its fiscal deficit. We were disappointed with the Budget as it highlighted the limited revenues government is expecting from its oil sector over the next few years. The stark reality is that oil revenues are projected to represent only 5.5% of total domestic fiscal revenue in 2011, rising to around 10% of revenues by 2013 – this is well below what we and the Ghanaian population expected. The finance ministry noted that oil revenues will remain limited over the medium term as a result of a cost-recovery phase that may last for up to five years.

GNPC will absorb a substantial amount of oil revenues for further investment

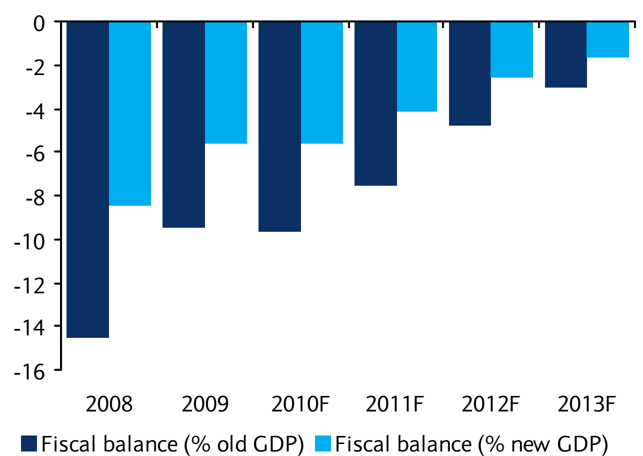
Admittedly, the government has been conservative in its oil assumptions and if we assume our commodities team projection of an average oil price of USD85/bl in 2011 and average production of around 100,000bpd, then the government may receive nearly 40% more revenues in 2011 from oil than estimated in the budget. Still, oil revenues as a proportion of the government's normal budgetary spending will not be considerable as a large chunk will remain with the Ghana National Petroleum Company (GNPC) to fund its investments. The government expects GNPC revenues to account for as much as 45% of total oil revenues in 011 but to decrease s a percentage after 2011, as oil revenues rise.

Figure 3: Inflation outlook remains positive



Source: BoG, Absa Capital

Figure 4: Fiscal discipline needs to be restored



Source: MoFEP, Absa Capital

Government will need to work hard to reduce the fiscal deficit without too much reliance on oil revenue

The oil revenues that will be channelled into the budget, excluding GNPC revenues, will be further reduced should parliament approve the proposal to save 30% of these amounts in a Stabilisation and Heritage fund (note the oil bill has not yet been passed by parliament). In practice, it means that of the initial USD400mn oil revenues projected for 2011 in the budget, we estimate that only around USD160mn will be used for normal budget activities, such as capital and other spending, while USD70mn will be saved (with the remainder going to the GNPC). Although the fiscal revenues from oil are projected to triple over the next three years, and even though these are conservative amounts, the fact remains that at least during the cost-recovery period, fiscal revenues will likely not be substantial enough to fund huge infrastructure outlays. Hence, in our view, the government will have to reduce its fiscal deficit without too much reliance on oil revenues. It also suggests that the government may need to work hard to contain spending on its large wage bill (already around 7% of GDP using new GDP estimates), which, according to the budget estimates, should double over the next few years, owing to the implementation of the new salary structure.

We remain concerned about fiscal discipline

Looking beyond oil and considering the budget outlook it is critical to distinguish between underlying budget trends and the headline numbers, which have been affected by the recent change in methodology for GDP (and its subsequent rise by about 60%). On the surface, the new GDP figures have helped the government's fiscal metrics, as deficits and debt levels look to have fallen significantly. However, it is important to note that the actual cedi amounts behind the new ratios have not altered. So as much as the 2010 budget now looks to be below the 7.5% of GDP fiscal target, against the initial comparable GDP figure, the overshoot is substantial. Similarly, next year's deficit projection of 4.2% of GDP in 'old money' is well above the targets set out in the initial budget plan.

Rating agencies unlikely to downgrade Ghana on fiscal concerns but will monitor it closely, in our view

The impact of the new GDP series is also very evident with regard to debt, where the 'new' figure of 36% of GDP looks far more comfortable than the 'old' 68%. However we are concerned that Ghana's appetite for debt remains large, as total public debt rose from USD8.5bn in September 2009 to USD11.3bn a year later. We think plans to issue another Eurobond and indications that the country may step up borrowing to expand infrastructure are worrying; and the IMF and S&P have both expressed concern about fiscal and debt sustainability. Although we do not expect ratings agencies to downgrade Ghana, the government will be closely monitored to see whether it can maintain fiscal discipline, in our view.

Figure 5: Selected macroeconomic forecasts (based on new GDP estimates)

	2006	2007	2008	2009	2010F	2011F	2012F
Real GDP (% y/y)	n/a	6.5	8.4	4.7	6.5	12.8	10.5
Nominal GDP (USDbn)	20.4	24.8	27.9	26.2	31.3	41.4	53.0
CA (% GDP)	-5.1	-8.7	-12.7	-4.6	-6.1	-2.2	1.4
FX reserves (eop)	2.3	2.8	2.0	3.2	4.1	4.7	5.3
External debt (% GDP)	10.7	14.5	14.1	19.1	19.2	16.7	14.1
Domestic debt (% GDP)	25.2	26.5	17.2	16.2	30.0	14.2	12.3
Overall fiscal balance (% GDP)	-4.6	-4.9	-8.5	-5.6	-5.6	-4.2	-2.6
CPI (% y/y, eop)	10.9	12.7	18.1	16.0	9.6	10.8	12.4
Currency per USD (eop)	0.92	0.97	1.21	1.43	1.42	1.39	1.39
Benchmark policy rate (%, eop)	12.50	13.50	17.00	18.00	13.50	14.00	14.50

Source: IMF, BoG, GSS, Absa Capital

EMEA: GULF COOPERATION COUNCIL (GCC)

One year on

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One year after the Dubai World standstill, the Dubai sovereign balance sheet seems to be more explicitly shouldering the burden of debt-restructuring. Prospects for increasing OPEC production in 2011 and projected infrastructure spending should keep Saudi Arabia and Qatar's contribution to regional growth the highest. We remain cautious on Dubai and Abu Dhabi credit but still like Qatar despite prospective issuance related to the 2022 World Cup.

Strategy: *Remain cautious on Dubai and Abu Dhabi, switch into Qatar and Qatari Diar 20s from Egypt 20s*

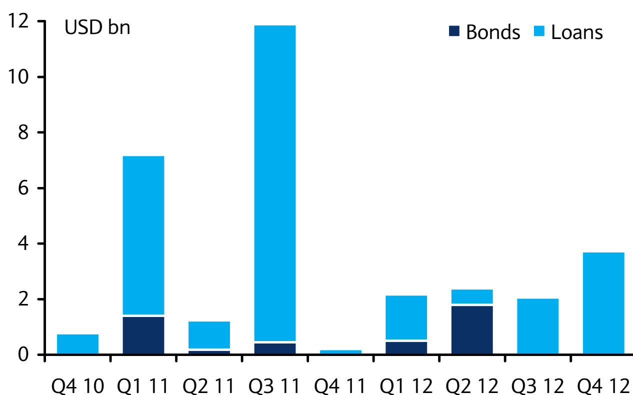
Strategy: The outlook for Dubai remains challenging, in our view. The emirate faces considerable debt maturities in 2011(Figure 1); most notable from the sovereign perspective is the USD4bn ICD loan maturing in August. Moreover, the recent decision of the Dubai government to provide USD2bn to Dubai Holding (DH) highlights the uncertainty around the additional burdens the Dubai sovereign balance sheet will have to bear in the corporate restructuring process. Against this background, we maintain our cautious stance on Dubai sovereign credit. In Abu Dhabi, an imminent decision on a possible bailout of Aldar, which we think will be provided, will likely be an important driver of market sentiment. The channelling of funds from the Abu Dhabi sovereign to cash-strapped corporates and the related issuance outlook, with heavy issuance expected from both the quasi-sovereigns and the sovereign, are likely to put some pressure on Abu Dhabi sovereign spreads. All of which warrants caution, in our view. Among the GCC sovereigns, Qatar remains our top pick, despite a potentially increased issuance outlook over the coming years to finance investments for the FIFA 2022 World Cup. Robust growth and a strong balance sheet, coupled with attractive valuations versus other credits in the MENA region support our positive view. In particular, we recommend switching out of Egypt 20s into Qatar 20s or into Qatari Diar 20s, the latter enjoying an unconditional and irrevocable guarantee from the sovereign, while offering some pick-up in spread.

One year on: Dubai Inc restructuring continues

After Dubai World, next comes Dubai Holding and ICD

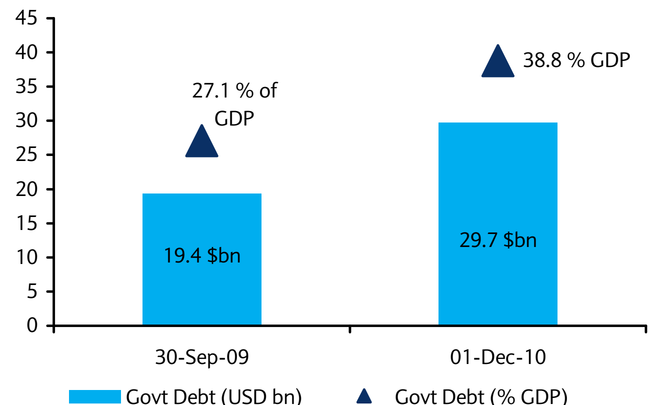
One year after Dubai World (DW) announcing a standstill in November 2009 on its USD25bn debt, Dubai is in the middle of restructuring the debts of its two other conglomerates, Dubai Holding (DH) and Investment Corporation of Dubai (ICD). Over the

Figure 1: Dubai's non bank foreign currency debt maturities



Source: Dealogic, Barclays Capital

Figure 2: Dubai sovereign debt: looking back… and forth



Note: Dubai GDP is based on IMF estimates of UAE GDP. Government debt includes local and foreign currency debt as reported by the Dubai Department of Finance but excludes guaranteed debt of DEWA (USD1.25bn) and PCFC (USD1bn).
Source: Dubai Government, Dealogic, Bloomberg, Barclays Capital

coming months, the progress on and completion of these negotiations with creditors will, in our view, be a key driver of market sentiment towards the emirate. Developments here will dictate the pace of its economic recovery in 2011 and beyond as it attempts to secure the capital needed to refinance its debt and fund much-needed growth-generating projects both in the public and the private sectors.

Dubai entities need to refinance around USD20.5bn in 2011

We had estimated DH's foreign currency debt to be about USD9.5bn, while ICD's debt (including those of its related entities) amounts to USD13.3bn. We had indicated also that in 2011, Dubai entities would need to refinance an estimated USD20.5bn of maturities falling due (*GCC Handbook: Drilling down*, September 2010), the equivalent of 26.7% of Dubai's GDP, or about 62% of UAE central bank FX reserves. While the majority of the debt consists of loans extended to private and quasi-sovereign corporates, at least USD4bn of ICD debt (maturing in August 2011) is explicitly considered to be part of sovereign debt, as indicated by the Dubai Department of Finance. Obviously, all of these debts are under negotiations for restructuring and rollovers under the supervision of the Dubai Support Fund.

Dubai sovereign balance sheet is bearing a bigger debt burden

Over the past year, Dubai's sovereign balance sheet has shouldered much of the restructuring. In addition to taking on explicit contingent liabilities, the government used part of the proceeds of its newly issued bonds to provide entities whose credit profile is weak, with lifelines to repay some of their imminent obligations. Recently it granted USD2bn facility to DH. In fact, total Dubai sovereign debt increased from an estimated USD19.4bn at end September 2009 (the equivalent of 27.1% of Dubai's GDP), to USD29.7bn in December 2010, or 38.8% of GDP, almost one year after (Figure 2). At the same time, the cost at which the Dubai government has been raising financing has increased exacerbating further concerns about medium-term fiscal sustainability, given the slow recovery in the emirate.

UAE non oil growth remains subdued

In fact, UAE's non-oil sector activity, to which Dubai contributes about 55%, remains constrained by a subdued level of credit growth to the private sector. Over the past nine months, credit growth registered a mere 1% y/y, lower than in Saudi Arabia and Qatar. While PMIs indicate an expansionary mode of activity, they have not exceeded the 52-53 level over the past year, confirming a slow recovery path (Figure 4). In fact, loan growth remains weak, particularly in Dubai, where restructuring is still weighing on employment and investment holding back banks from growing their lending portfolios. In Abu Dhabi however, government-sponsored projects are driving credit extension, averaging 4.5% y/y over the first nine months of the year (Figure 3).

Figure 3: Selected UAE banks: credit extension and liquidity indicators

	Loan growth (%)			Net loans to customer deposits (e.o.p)		
	2009 (y/y)	Jan-Sept 2010	June-Sept 2010	Dec-09	Jun-10	Sep-10
Dubai						
ENDB	2.7	-6	-1.3	118.5	103.16	101.5
Mashreq	-0.14	-8.5	-0.7	85.6	87.6	85.4
DIB	-5.1	0.6	0.4	77.2	77.8	81.4
Abu Dhabi						
ADCB	6.9	3.1	1.2	135.3	122.6	119.5
NBAD	18.3	5	0.6	109.1	120.4	115.4
FGB	13.8	5.7	1.4	104.6	106.5	103.6

Source: Respective banks financial statements, Barclays Capital

Credit growth is still lagging notably in Dubai

We expect corporate and sovereign issuance to pick up across the board

We expect banks' balance sheet clean-up processes to persist until towards the end of 2011, as Dubai entities' debt restructuring slowly winds down (see *MENA Monthly: Flows in, flows out*, 29 October 2010), allowing for a gradual increase in credit extension. In the meantime, we expect corporate issuances to support financing of infrastructure projects in Dubai and help spur non-oil growth further. In Abu Dhabi too, we expect a combination of increased government spending and greater supply of both sovereign and corporate bonds to support the financing of the government's investment plan. Absent a significant increase in UAE oil production, we maintain our 2011 growth forecast at 3.7% y/y.

One year on: Oil demand, investment plans and the 2022 World Cup

Qatar's prospective increases in net exports and significant spending should boost growth to higher levels

Plans to host the 2022 World Cup will maintain high growth over the coming decade

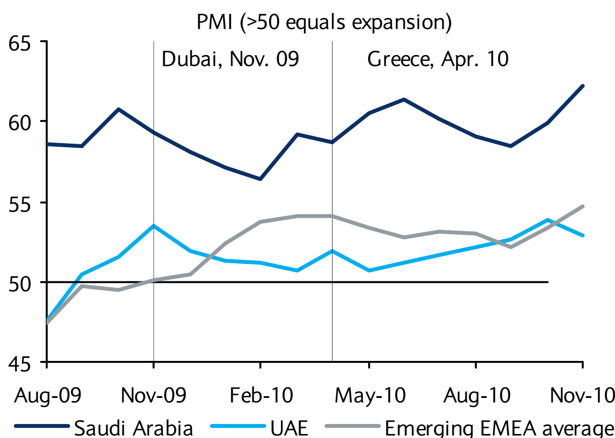
Against a slow and challenged recovery in the UAE, Saudi Arabia and Qatar continue to drive regional growth (Figure 5). In Qatar, continued expansion of gas production (with the completion of Qatar Gas trains 6 and 7 and the Pearl GTL project), and accelerated credit extension by local banks (averaging 16.7% over the first half of their fiscal year) is supporting domestic demand, which along with soaring net export growth of gas and associated condensates, should boost real GDP growth to about 19% y/y in 2010-11, before slowly tapering off as gas expansion programmes near their completion. With Qatar now officially hosting the FIFA World Cup in 2022, prospects of large-scale spending on infrastructure starting next year will significantly boost non-oil growth in 2011-12 and beyond as the country seems to be preparing a USD140bn investment plan over the next ten years as announced by the Qatari Minister of Finance. We therefore adjusted upwards our forecasts for the coming two years and will revisit our growth projections as soon as further information is provided on the timetable of the 2022 World Cup infrastructure plans.

Prospects for expanding oil output are real but remain limited…

… as demand pushes prices upward

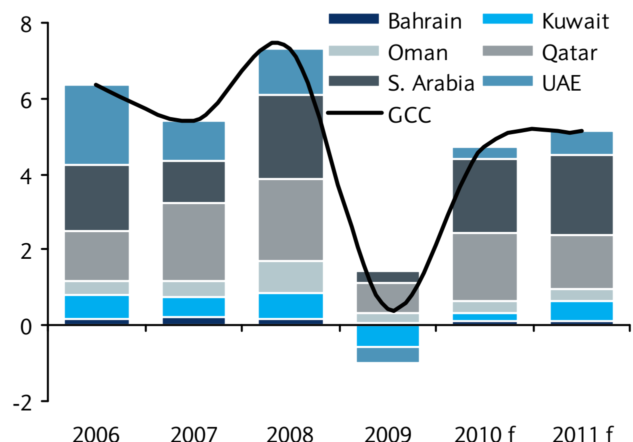
The need to boost non-hydrocarbon growth will remain a top priority for other GCC OPEC member countries, even if prospects for raising oil production improve (the latter rose 1.1% y/y in the first 10 months of 2010). Average GCC oil production is projected to increase to 16.1mn barrel per day (bpd) in 2011 from the current 2010 average of 14.8mn bpd. Accordingly, in 2011-12, we expect a larger contribution to growth to come from the oil sector as OPEC quotas ease on the back of an accelerating OECD and Non-OECD demand that could push prices upwards, as witnessed recently (we forecast 9% and 24% y/y increases in WTI in 2011 and 2012, respectively). The call on OPEC oil is likely to see Saudi Arabia's production rise to levels at or above 9mn b/d, driving hydrocarbon growth to 4% y/y up from 1.8% y/y in 2010, and pushing overall growth to 4.1% y/y in the Kingdom.

Figure 4: Latest PMI improvements reflect ongoing recovery



Source: Haver Analytics, Barclays Capital

Figure 5: Saudi Arabia and Qatar will drive GCC growth



Source: Haver Analytics, Barclays Capital

But large scale government spending will continue

Expansionary fiscal policies will thus continue to be the main engine of growth across the GCC for the current year and into 2011, focusing on upgrading and modernising the countries' infrastructure base in a way that supports subdued private sector activity. This is particularly true in Saudi Arabia, where we expect the 2011 budget draft in late December, confirming commitment to the announced investment pipeline, as well as in Kuwait, in line with the ongoing implementation of its USD107bn development plan. Even in Oman, the government announced a likely 9% increase in its expenditure to a historical high of OMR8bn. The ability of the private sector to expand is, however, still constrained by funding availability. On the one hand, credit to the private sector has yet to recover with GCC credit growth still growing at below 5% y/y. On the other hand, lending by foreign banks to the region is still at an all-time low (Figure 6).

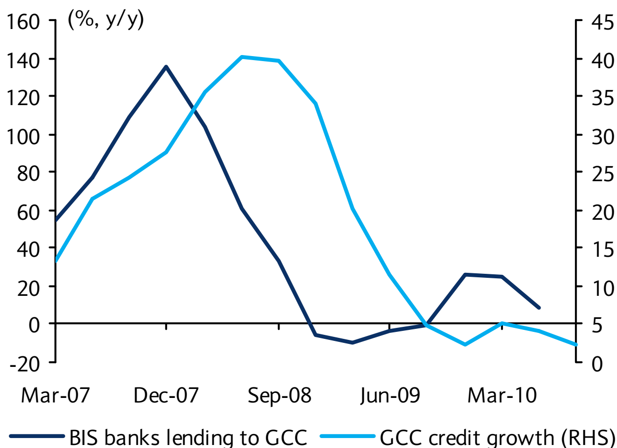
Inflation continues to rise

Driven by higher food inflation

Housing costs will drive inflation the most in Saudi Arabia and Kuwait

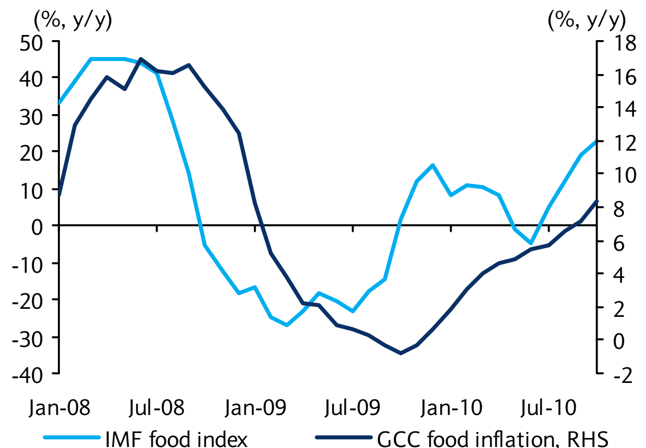
Against this background, inflation has been on an upward trend since the beginning of the year. It reached 4.2% y/y in September from its lowest point of 1.2% in October 2009. Three factors have been influencing, and are likely to continue to influence, the direction of inflation in the GCC: the relative performance of the US dollar, global commodity prices, and housing market conditions. We believe that recent bouts of USD weakness had little, impact on prices given weak inflation in most trading partners, and should be downplayed given downside risks to the USD over the coming months and into 2011. International food prices, however, will continue to affect food inflation in the GCC, with food prices in Bahrain, Kuwait, Saudi Arabia and the UAE exhibiting the highest correlation to changes in international food prices (Figure 5). Housing market conditions will also remain a major driver of GCC inflation and explain variations across countries. In Kuwait and Saudi Arabia, housing and rental costs have an average weight of 22% in the CPI basket, pushing headline inflation to its highest levels of 5.1% and 5.8% y/y in October for the two countries, respectively. On the other hand, oversupply of housing units in Bahrain, Qatar and the UAE continue to drive prices downwards. We believe this pattern is likely to continue in 2011.

Figure 6: Credit growth and BIS banks lending to GCC



Source: Haver Analytics, BIS, Barclays Capital

Figure 7: Food inflation is on the rise



Source: Haver Analytics, Barclays Capital

Figure 8: GCC macroeconomic forecasts

	Real GDP (% y/y)						Hydrocarbon growth (% y/y)					
	2007	2008	2009	2010 f	2011 f	2012 f	2007	2008	2009	2010 f	2011 f	2012 f
GCC	5.7	7.3	1.0	5.2	5.7	6.3	-0.9	5.6	-4.6	5.7	6.0	6.0
Saudi Arabia	8.4	6.3	3.1	3.8	4.3	4.8	1.1	0.4	0.1	0.2	0.2	0.5
Bahrain	4.6	5.6	-4.4	1.9	4.5	5.0	-2.3	3.3	-11.4	1.0	4.5	4.4
Kuwait	6.8	12.8	3.4	4.5	4.6	4.1	-5.0	6.2	5.9	6.0	6.0	5.6
Oman	26.8	25.4	8.6	19.5	15.3	16.5	23.3	23.1	7.7	30.4	17.6	13.2
Qatar	2.0	4.2	0.6	3.7	4.1	4.7	-3.6	4.2	-6.7	1.8	4.0	5.2
UAE	6.1	5.1	-0.7	2.0	3.7	4.1	-2.7	1.6	-6.3	3.1	4.5	4.0
	Non-Hydrocarbon growth (% y/y)						Inflation (Avg, % y/y)					
	2007	2008	2009	2010 f	2011 f	2012 f	2007	2008	2009	2010 f	2011 f	2012 f
GCC	7.2	8.1	3.4	4.3	4.9	6.1	6.5	10.8	3.0	4.0	3.6	3.7
Saudi Arabia	9.6	7.2	3.3	3.5	4.5	5.0	3.3	3.5	2.8	2.9	3.2	3.3
Bahrain	6.3	6.5	0.0	2.5	4.5	5.4	5.5	10.6	4.0	4.8	3.4	2.9
Kuwait	12.0	14.8	2.1	4.4	4.8	4.5	5.9	12.5	3.6	3.9	2.9	3.3
Oman	30.6	27.8	9.6	8.5	10.0	15.0	13.6	15.2	-4.9	0.5	2.0	4.0
Qatar	4.7	4.3	3.8	4.4	4.1	4.5	4.1	9.9	5.1	5.4	4.4	4.0
UAE	1.6	6.3	1.0	2.1	3.5	0.0	11.6	11.5	1.0	1.8	2.5	2.9
	Current account balance (% GDP)						Fiscal balance (% GDP)					
	2007	2008	2009	2010 f	2011 f	2012 f	2007	2008	2009	2010 f	2011 f	2012 f
GCC	19.9	21.1	6.7	10.6	12.1	15.5	15.0	25.9	-1.2	3.4	6.3	7.2
Saudi Arabia	15.7	10.2	2.9	8.5	7.6	8.1	3.1	7.4	-5.1	-4.5	-4.3	-3.8
Bahrain	36.1	40.5	29.1	29.3	31.0	31.7	30.3	35.0	18.7	16.1	17.4	19.1
Kuwait	5.9	8.3	-0.6	2.7	3.4	3.7	0.2	0.3	-3.8	1.2	2.6	2.9
Oman	12.9	12.8	8.5	19.5	17.6	15.8	10.8	10.3	14.4	12.5	11.6	10.1
Qatar	24.2	27.8	5.6	7.8	8.0	16.5	12.2	32.5	-6.1	1.5	4.6	5.6
UAE	9.4	6.8	-2.6	9.7	9.5	8.8	21.5	20.5	-9.0	-4.8	2.2	4.4

Source: National ministries of finance and central banks, IMF, Haver Analytics, Barclays Capital

EMEA: HUNGARY

Policy uncertainty

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Hungary's outlook remains very uncertain. The government has embarked on a pro-growth strategy financed by aggressive ad hoc fiscal measures. This should support growth in the short term, but it could lead to fiscal deficits rising sharply again in 1-2 years. The government also plans to gain more influence on monetary policy, including a potential upward revision of the inflation target. This leaves investors, potentially, with a very volatile environment. Against this backdrop, we recommend paying 5y IRS and remain Underweight credit. We are neutral HUF.

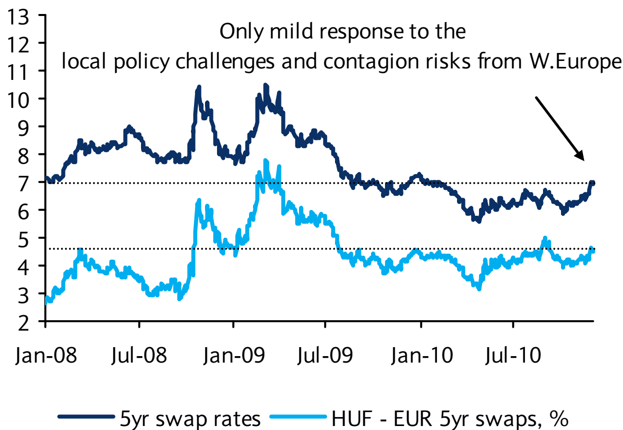
Strategy:
Neutral on HUF;
Pay 5y IRS;
Remain Underweight credit

Strategy: The outlook for Hungarian markets remains challenging. Certainly, technical factors look supportive, as investors seem generally underweight/short. However, this is not sufficient to make us feel bullish against a very risky fundamental backdrop. In local rates, we see: 1) significant uncertainties about conditions in the local fixed income market as private pension fund participation evaporates; 2) still-large gross funding needs; and 3) risks of further hikes by the NBH. We therefore recommend paying 5y IRS. The negative cost of carry/roll in paying the 5y (4bp per month) is around half the cost of paying shorter (2y) tenors and the 5y tenor is also the most liquid. We opt for a neutral stance on the HUF, as the current account remains in surplus, NBH could hike rates further, and we believe that the government may sell the FX assets it is likely to take over form the pension funds in Q1. On credit, we maintain an Underweight Hungary position in our Global EM credit portfolio. The recent underperformance and defensive investor positioning could create some room for rebounds in a supportive risk environment but, in our view, this is more than offset by the uncertainty over longer-term fiscal sustainability, as well as the heavy supply outlook for 2011 (EUR4-5bn). Finally, the close links to the euro area's banking sector imply potential contagion if this sector experiences stress.

Growth recovery well under way driven by exports

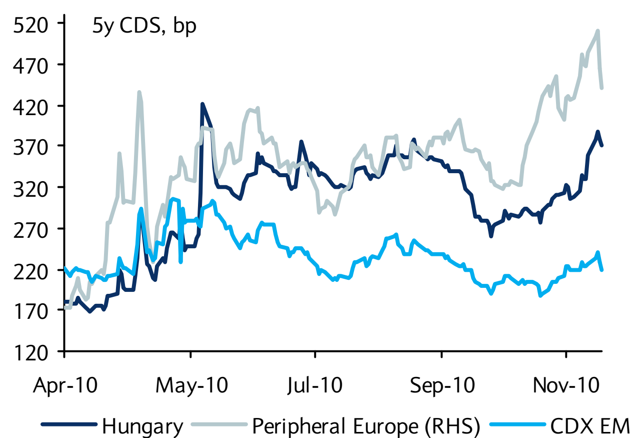
Hungary's output recovery continues to be driven by exports growth, which in large part is due to German demand for Hungarian industrial goods. Domestic demand remains sluggish thus far. Private sector lending continued to decline in Q3, albeit at a slower pace. Lending to households remains subdued, as the ban on FX mortgage loans since August accelerated

Figure 1: Light positioning, but premia could rise



Source: Bloomberg, Barclays Capital

Figure 2: Hungary: closing the gap to euro area periphery?



Note: Peripheral Europe is an equally weighted average of Portugal, Ireland, Italy, Greece, and Spain. Source: Markit, Barclays Capital

Employment rising, perhaps some lending pick-up in 2011

the decline of FX lending. This more than offsets the observed rise in HUF lending, and prospects for the latter are likely negatively affected by the NBH's initiation of a rate hiking cycle. Corporate lending could pick up first in 2011 on the back of the strong performance of export-oriented manufacturing firms. Household lending may follow, as employment further improves. However, the increased debt servicing burden from the large remaining stock of CHF mortgages continues to act as a constraint.

Far-reaching fiscal measures complicate economic projections…

…as potential behavioural reactions by corporates and households are not clear

But in the short term, growth is likely to receive a boost from fiscal policy

However, these projections have become complicated by the far-reaching fiscal measures implemented by the government (see below): eg, household consumption is likely to be supported by the reduction in the personal income tax; and investment, already expected to rise due to a number of larger FDI projects in the auto sector, could receive further support from corporate tax rate reductions, in particular in the SME segment. However, the behavioural effects are not unequivocal, especially when looking beyond the short term. The ad hoc sector-specific tax hikes (and their unknown future) have heightened uncertainty for many businesses, which could reduce their investment activity. Furthermore, households could also react to the drastic pension measures by increasing savings. That said, in the near term, we expect the impact from the government's aggressive fiscal policy to be clearly expansionary. Together with the continuing support from a robust-looking German growth outlook, this has made us revise Hungarian GDP growth to above 1% for this year and above 3% in 2011. In our baseline, we see growth further rising in 2012, but as explained, the uncertainty surrounding this forecast is particularly high as challenges in the fiscal outlook beyond the 1-2 year horizon could start to weigh on private sector confidence.

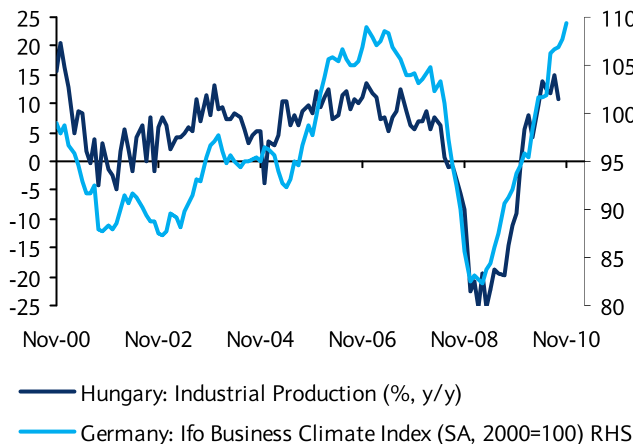
Current account remains in surplus

We believe the continuing strength in export performance coupled with the still-relative weakness in domestic demand will keep the current account in a small surplus this year and close to balance in 2011. As the structure of growth becomes more balanced, the current account should move into deficit again. While the coming on stream of ongoing FDI projects (eg, the Mercedes plant) should add to exports in 1-2 years, foreign firms' improving profitability is also likely to lead to a widening deficit in the income balance again.

Headline CPI inflation driven up by food…

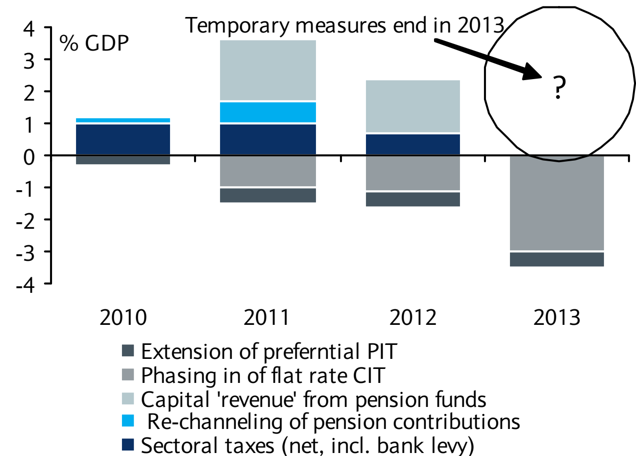
Headline inflation has recently re-accelerated to above 4%, but this has been driven mainly by food price inflation. Core inflation also accelerated slightly, but remains contained (1.8% in October) and there seems to be no evidence of labour market or demand pressures on inflation. The limited pass-through from the weaker exchange rate during the summer also suggests that the output gap remains significant. However, the NBH notes that food price

Figure 3: Hungary recovering nicely, helped by German growth



Source: Haver Analytics, Barclays Capital

Figure 4: But fiscal policy creates large uncertainties



Source: NBH, Barclays Capital

... but NBH is concerned about inflation expectations

inflation and other cost shocks (including the tax hikes on the energy, telecoms and retail sectors) will likely pass into core inflation in the coming months. It also emphasises that inflation expectations have stagnated at levels above the 3% target and that its own forecasts show the headline remains above target for the forecast horizon. Against this backdrop, the NBH surprised markets with a 25bp rate increase to 5.50% at its November meeting.

Surprise rate hike also motivated by discomfort with government's policy

Possible changes to Monetary Council…

…and to inflation target

Policy rates path could be volatile

The NBH's hike at this juncture is also a response to the rising unpredictability of fiscal policy and attempts by the government to gain more influence over monetary policy, in our view. The government signalled that it could change the law to enable it to nominate all four new Monetary Council (MC) members, rather than leaving two of them to be proposed by the NBH, as is currently the case. This could create a situation where, starting in March, the four new government-appointed MC members could overrule the governor and his two deputies at rate-setting meetings by simple majority. In addition, local press reports have suggested that the government is also contemplating an upward revision of the inflation target to 3.5%. These issues make the monetary policy outlook highly uncertain. We forecast that the policy rate will be hiked further to 6.0% before end-Q1 11 and that it may remain on hold afterwards; ie, if new MC member are nominated by the government, it seems unlikely they would support further hikes. However, it is not implausible that rates could be hiked even further in the next few months, eg, in the event of a sharp rise in risk premium on HUF assets, but are then lowered again due to a change in the MC's policy stance.

Fiscal policy is key to uncertainty

Immediate headline deficit reduction through temporary 'crisis taxes'

…but permanent reductions in PIT and CIT

The key to Hungary's economic outlook and asset valuations is the government's fiscal policy strategy, in our view. Soundly winning the local elections in early October seems to have strengthened the government's resolve to stimulate domestic demand by income taxes reductions: it plans gradually to phase in a 16% flat-rate tax by 2013 and, over the same horizon, to extend the preferential 10% CIP rate to all corporations. To reach the EU-agree deficit targets of 3.8% this year and below 3.0% in 2011, it has decided on a financial sector tax (significantly higher than that in other countries) and ad hoc 'crisis taxes' on the energy, telecom and retail sector.

De-facto re-nationalisation of private pension fund assets

Perhaps more worrisome, large 'savings' are achieved by the dismantlement of the capital funded pension pillar: ie, not only a re-channelling of mandatory contributions to private pension funds (1.3% of GDP annually) back into the public system – something other CE countries have partially done as well – but also the return of most of the accumulated savings in these funds (roughly 10% of GDP) as 'revenues' to the budget. Although participants can choose whether to participate, the incentives are so aggressively set – loss of all rights to the public pension – that a very high acceptance of the offer by end-January 2011 (official deadline) can be expected. According to ESA 95 rules, such a return of assets can be booked as revenue in the budget. In 2011 budget, only assumes about 2.0% of GDP (ie, only 20% of the pension assets). A 100% return would imply that instead of a deficit of below 3.0%, Hungary could report an ESA 95 surplus of c.5.0% in 2011.

Risk of re-surge in fiscal deficits past 2012, as structural balance has deteriorated

However, such accounting exercises, some of which are also not yet fully clear, only cover up a significant deterioration in the 'structural' balance (which excludes the temporary effects). Without additional measures, the deficit could rise again to 5-6% of GDP after 2012, and, similarly, the debt-to GDP ratio would start rising again. The government signalled that it may announce structural (spending) reforms in Q1 11, but there are no concrete commitments thus far, and government officials have also hinted that some of the 'temporary' crisis taxes could become permanent. Notably, the government also assumes real GDP growth rates of above 5% after 2012, which illustrates its hope that high growth may take care of the postponed structural fiscal adjustment.

Challenging government financing outlook

This is a risky strategy, in our view, particularly as the government has financing needs of about EUR24bn next year (about 22% of GDP). Of these, EUR4bn are external obligations (a EUR2bn repayment to the EU and EUR2bn in Eurobond amortization), for which it plans to issue EUR4bn in international bonds. If that proves difficult, eg, in light of recent rating downgrades, it could also use up part of its remaining EUR2.5bn in FX deposits and possibly sell some of the foreign assets it is likely to take over from pension funds (which have about 20% of their investments in foreign assets). However, we think all of these measures would be viewed as ad hoc gap fillers, leaving investors with little confidence in the outlook, e.g. when the IMF repayments commence in 2012. Similarly, the government's intention to issue about EUR5.3bn of HUF bonds in the local markets is likely to be complicated by the lack of demand from the private pension funds, which used to invest about 50% of their assets in such bonds. Perhaps a credible announcement of far-reaching structural reforms over the next few months could render the outlook more positive. However, for now, we chose to remain defensive.

Figure 5: Hungary macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	1.0	0.6	-6.3	1.2	3.1	3.7
Domestic demand contribution (pp)	-1.1	0.7	-10.3	-1.1	2.8	3.6
Private consumption (% y/y)	-1.6	-0.6	-6.7	-3.1	3.0	3.9
Fixed capital investment (% y/y)	1.6	0.4	-6.5	-1.1	3.2	6.2
Net exports contribution (pp)	2.1	0.0	4.0	2.3	0.3	0.1
Exports (% y/y)	16.2	5.6	-9.6	13.6	9.1	9.9
Imports (% y/y)	13.3	5.7	-15.4	12.4	10.6	9.7
GDP (USD bn)	138	155	131	127	142	157
External sector						
Current account (USD bn)	-9.7	-10.7	-0.5	1.1	0.4	-0.8
CA (% GDP)	-7.0	-6.9	-0.4	0.9	0.3	-0.5
Trade balance (USD bn)	-0.1	-0.6	5.6	6.1	4.9	3.8
Net FDI (USD bn)	2.2	3.7	-0.3	-0.1	0.5	0.6
Gross external debt (USD bn)	148	169	176	165	156	157
International reserves (USD bn)	24.0	33.9	44.2	43.2	40.0	35.0
Public sector						
Public sector balance (% GDP)	-5.0	-3.7	-4.4	-3.9	-2.9	-3.0
Primary balance (% GDP)	-0.9	0.4	0.4	0.0	0.9	0.8
Gross public debt (% GDP)	65.9	72.9	78.4	78.5	77.3	75.1
Prices						
CPI (% Dec/Dec)	7.4	3.5	5.3	4.1	3.7	3.4
EUR/HUF, eop	253	265	271	279	272	280
	1y ago	**Last**	**Q4 10F**	**Q1 11F**	**Q2 11F**	**Q3 11F**
Real GDP (y/y)	-4.4 (Q4)	1.6 (Q3)	2.0	3.4	3.3	2.9
CPI (% y/y, eop)	5.6 (Dec)	4.2	4.1	4.4	4.1	3.9
Exchange rate (EUR/HUF, eop)	274 (Dec)	278	279	280	280	272
NBH policy rate (%, eop)	6.25 (Dec)	5.50	5.50	6.00	6.00	6.00
Market implied rate (%, eop)	NA	NA	5.75	6.00	6.25	6.50

Source: Barclays Capital

EMEA: ISRAEL

New policy phase – dealing with strength

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Israel's economic performance is improving. Growth has broadened and strengthened; the economy seems to be well on the way to full recovery. However, inflation is rising and presents a possible macroeconomic risk. Israel has been running current account surpluses for some years from gains in high-tech exports. Fiscal accounts have been improving, and on current trends Israel will transform from a high debt to a low debt country in the next decade. Production of natural gas is set to provide a financial windfall and force Israel to deal with its surpluses. The BoI has already increased international reserves to prevent appreciation. In the next stage the government will have to develop supplemental ways to contain appreciation.

Strategy:
FX – Long shekel vs basket of EUR and USD

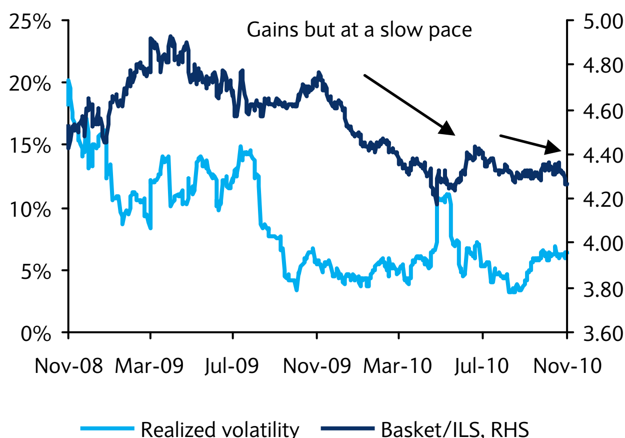
Strategy: The shekel remains a good currency to be long, albeit one in which we expect only slow gains on a trade-weighted basis. The Bank of Israel maintains a very tight leash on the exchange rate through its active currency interventions. However, the strength of the economy means that the BoI will allow some currency gains to come through and will be delivering further interest rate hikes as well. A stronger exchange rate will be helpful in terms of containing inflation, although we stress that this is not the main concern right now, given the other more important drivers of inflation (housing) that are relatively insensitive to the stronger currency. Low speculative positioning in the shekel and very favourable long-term BoP dynamics make the shekel a structural long for us, although investors should not be anticipating more than 5-7% pa trade-weighted appreciation (Figure 1). On Israeli swaps and bonds, we remain broadly neutral: we are about halfway through the hiking cycle, which leaves the front end still vulnerable to yield upside, while at the back end of the Israeli curve, the end of the bull flattening trend in Treasuries and Bunds deprives the market of a source of support that had previously existed.

Growth performance has been excellent

Israel's economy seems to be headed towards full recovery

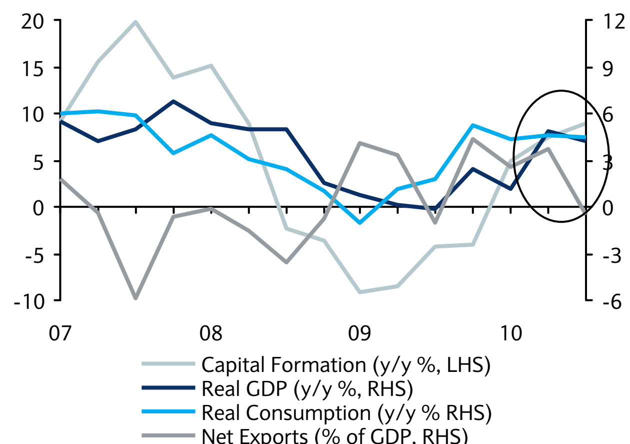
Israel's economy appears headed for a full recovery, growing at a rate of 4% y/y in 2010 (Figure 2). Net exports were crucial in the initial stage of the recovery but now consumption and investment have taken over. After a temporary dip in growth in Q3 because of a drop in

Figure 1: Comfortable long (in the shekel basket)



Source: Bloomberg, Barclays Capital

Figure 2: Domestic demand compensated for declining exports in Q3



Source: Israel Central Bureau of Statistics, Haver Analytics

We view overheating as an increasing risk, and we are increasing our growth forecast

exports (-10% q/q, annualized), growth appears to be rebounding in Q4. Previously we had thought that a derailing of the recovery was a risk. Though we are staying with our forecasts, we are more confident and recognise upside risk and possible overheating of the economy. We see growth in 2010 at 3.8%, accelerating slightly to 4.0% and 4.2% in 2011 and 2012, respectively. This assumes continuation of strong trends in consumption and investment into 2011-12. Thus, domestic demand rises while there is a gradual decrease in reliance for net exports as a driver of growth.

Inflation becoming a risk

We expect the pace of inflation to quicken in Q4 10 and acknowledge upward risks to inflation in 2011

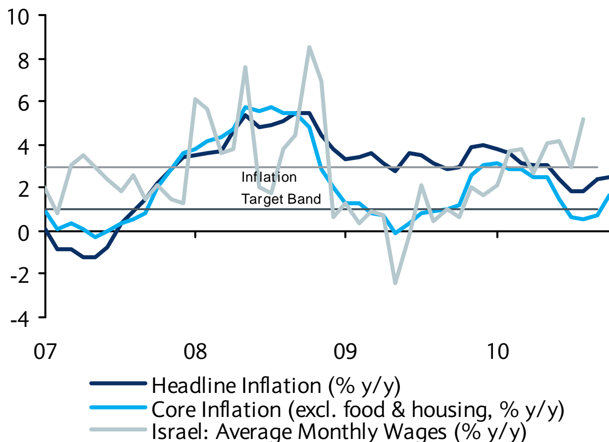
Inflation has been rising in recent months, reaching 2.5% y/y from 1.8% (Figure 3). Most of the increase has been because of food prices, but not exclusively. In our opinion, inflation is becoming a macroeconomic risk in Israel. Pressures on inflation have come from housing where prices are up 20% y/y. Now unemployment is down to pre-recession levels and wages are starting to rise. Finally the government is continuing to increase administrative prices. We expect the pace of inflation to quicken from current levels and stay at 2.7% in 2011. The main factors will be a rise in core inflation, with housing and food inflation remaining elevated but not accelerating. The risk is that growth heats up more and pushes core inflation higher as labour markets heat up.

Monetary policy tightening to continue

With the policy rate at 2.0%, real rates are negative and the BoI has reason to keep raising rates to normalise monetary policy and perhaps quicken the pace slightly

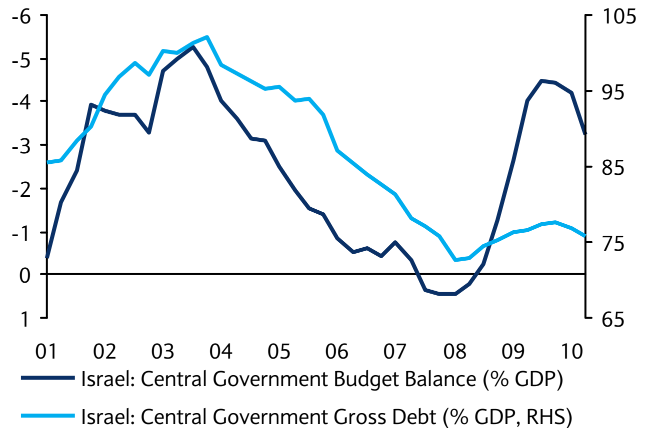
The BoI has been able to extricate itself from the accommodative monetary policy that existed in 2009 without much collateral damage to the exchange rate and growth. Rates have been increased 150bp and, although still low, are in a more normal range. The BoI has successfully frozen money supply at mid-2009 levels and therefore gone some way towards sterilizing excess liquidity. The currency has continued to appreciate in real terms, but the overall appreciation has been very modest. The BoI has had to accumulate large reserves in its quest to lean against currency appreciation. These reserves have greatly improved the economic fundamentals of Israel, which unfortunately is another reason for currency appreciation. With the policy rate at 2.0%, real rates are negative and the BoI has reasons to keep raising rates to normalize monetary policy and perhaps to quicken the pace slightly. There are still several factors that may cause it to stay with its historically slow pace of tightening. Major global central banks retain their extremely low rates because of continued economic challenges. Thus, the BoI has concerns about capital inflows and currency appreciation pressures.

Figure 3: Wage inflation and core are rising



Source: Israel Central Bureau of Statistics, Haver Analytics

Figure 4: Government debt ratio falling as planned



Source: Israel Ministry of Finance, Central Bureau of Statistics, Haver Analytics

Fiscal policy gaining strength

The Israeli government is actively lowering deficits and debt levels

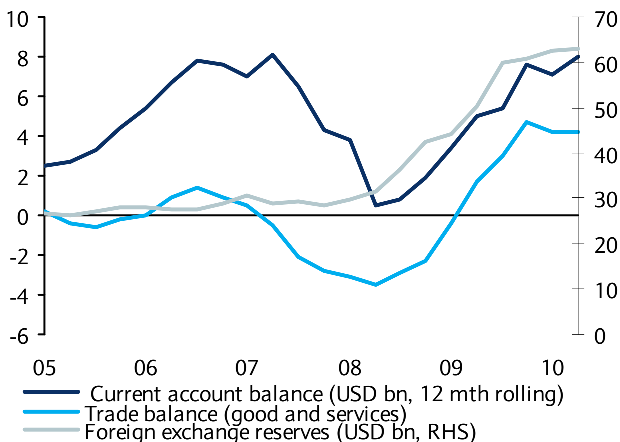
Fiscal prospects are excellent as revenues have been rising rapidly on higher economic growth. The Israeli government is actively lowering its deficits and debt. It is keeping expenditures under control and the buoyant economy is contributing to revenue collection. Revenues have been increasing at a 10% clip y/y in 2010. The official upper limit on the deficit for 2010 is 5.5%. However, at this time it appears that the 2010 deficit will be between 3.5% and 4% of GDP as revenues have been better than anticipated (Figure 4). In addition, according to the recent IMF report, the government is planning to reduce the deficit to 3% in 2011 and 2% in 2012. In the next few years the government plans to lower the deficit to 1% of GDP per annum. This will help bring overall government debt levels towards the 60% of GDP target sooner. The government is putting a priority on bringing down the level of government debt, which is quite high. If outperformance on revenue continues, tax cuts could be expected.

Exchange rate pressure on balance of payments strength

Israel is already running current account surpluses and is about to receive a huge windfall from natural gas production

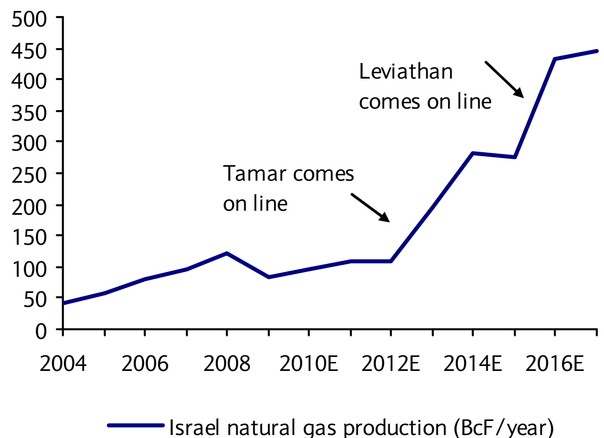
Israel current account surpluses have been supported by high-tech exports, particularly services, as well as government and private transfers (Chart 5). The recent discoveries and development of natural gas will improve Israel's balance of payments even more over the next few years. The natural gas reserves offshore are currently estimated at 26 Tcf (trillion cubic feet proven and probable), equivalent to about 4.5bn barrels of oil. Two smaller fields (1.5 Tcf) are already producing (Figure 6). Another large field (8.5 Tcf) will be producing in about two years. The largest field, representing half of the reserves, is only now being developed and could be producing in five years. We expect proven reserves to expand faster than they are depleted. At this time energy companies are already producing natural gas at a rate of about 50,000 BOE (barrels of oil equivalent) per day. This is being absorbed into the economy along with about 230,000 barrels per day of imported oil and additional imports of coal. Given total energy consumption of about 125mn barrels per year (equivalents) in all forms of energy, gas reserves could supply all of Israel's energy needs for the next 40 years. As natural gas production increases, we expect increasing conversion of electricity generation and other operations to natural gas away from coal and oil. In the end, Israel will likely be exporting natural gas and continuing to import oil, with the possibility of eventually becoming a net exporter of energy (through pipelines and liquids). Total Israel energy imports are running at a rate of USD10bn (-4% of GDP) in 2010. Based on our

Figure 5: Current account surpluses rising



Source: Israel Central Bureau of Statistics, Haver Analytics

Figure 6: Natural gas production to expand rapidly



Source: Israel Central Bureau of Statistics, Haver Analytics

estimates, Israel's natural gas production will increase from USD1bn in 2010 to about USD6bn per year in 2016 (2.4% GDP at current prices). While this will be partly offset by higher energy consumption, Israel's energy trade deficit should decline boosting current account surpluses.

The government will have to implement measures to deal with the increases in natural gas production

The main macroeconomic risk is that energy production leads to strong currency appreciation, hurting domestic industries. In our view, the accumulation of foreign reserves by the BoI has been an appropriate response to the existing current account surpluses. However, when energy production kicks up, the efforts of the BoI will need to be supplemented. The government will need to use its tax-royalties windfall from energy production in ways that prevent excessive currency appreciation. We expect that it will establish a sovereign wealth fund to channel some of the foreign exchange earnings out of local markets. In addition, the government could use some of the funds to finance major infrastructure improvements that would further improve private sector productivity.

Figure 7: Israel macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y) 1/	5.2	4.0	0.7	3.8	4.0	4.2
Domestic demand contribution (pp)	6.1	2.9	-0.2	3.1	3.7	4.1
Private consumption (% y/y)	5.4	2.7	1.8	4.0	3.8	3.8
Gross fixed capital formation (% y/y)	9.6	2.7	-10.0	2.0	7.5	8.6
Net exports contribution (pp)	-0.7	1.6	0.5	0.8	0.3	0.0
Exports (% y/y)	9.9	6.2	-12.5	12.7	5.8	6.8
Imports (% y/y)	11.8	2.7	-14.0	11.3	5.4	7.2
GDP (USD bn)	167	202	192	218	234	252
External sector						
Current account (USD bn)	4.9	1.3	7.2	7.9	7.0	6.1
CA (% GDP)	2.9	0.7	3.7	3.6	3.0	2.4
Trade balance (USD bn)*	-2.2	-3.1	4.3	4.2	4.3	5.2
Net FDI (USD bn)	0.2	3.7	2.6	3.1	3.5	3.8
Other net inflows (USD bn)	7.4	-8.2	3.2	5.6	6.1	6.8
Gross external debt (USD bn)	90	87	92	97	102	107
International reserves (USD bn)	28	42	60	72	88	105
Public sector						
Public sector balance (% GDP)	0.5	-1.2	-5.2	-4.0	-3.0	-2.0
Gross public debt (% GDP)	75.8	75.2	77.6	74.3	71.4	68.2
Prices						
CPI (% Dec/Dec)	3.4	3.8	4.0	2.7	2.7	2.5
USD/ILS, eop	3.85	3.80	3.78	3.67	3.50	3.50
	1yr Ago	**Last**	**Q4 10F**	**Q1 11F**	**Q2 11F**	**Q3 11F**
Real GDP (y/y)	-0.2	4.3	4.1	4.3	3.9	4.0
CPI (% y/y, eop)	2.9	2.5	2.8	2.9	2.8	2.8
Exchange rate (eop)	3.79	3.67	3.67	3.65	3.60	3.50
BOI policy rate (%, eop)	0.75	2.00	2.25	2.50	2.75	3.00
Market implied rate (%, eop)			2.25	2.50	2.75	3.00

Note: * Includes goods and services. Source: Bank of Israel, Ministry of Finance, Central Bureau of Statistics, Haver Analytics, Barclays Capital

EMEA: KENYA

Encouraging outlook, but…

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Prospects for 2011 have improved owing to a reduction in political risk, policy support, and an increase in tourist arrivals. Moreover, the recent upgrade of Kenya's sovereign rating by S&P serves as a vote of confidence for the country's positive political and economic outlook. However, economic risks remain, particularly if conditions in Europe – Kenya's largest export market – deteriorate further.

Strategy: Local debt remains at unattractive compared with its regional peers. The most recent issue was a 5y bond, which had a yield of 6.67%. In our view, although the borrowing requirement is expected to decline in 2011, yields may track higher in line with the anticipated tightening in monetary policy.

We expect policy tightening only likely late in 2011; Kenya still plans to issue maiden Eurobond in 2011

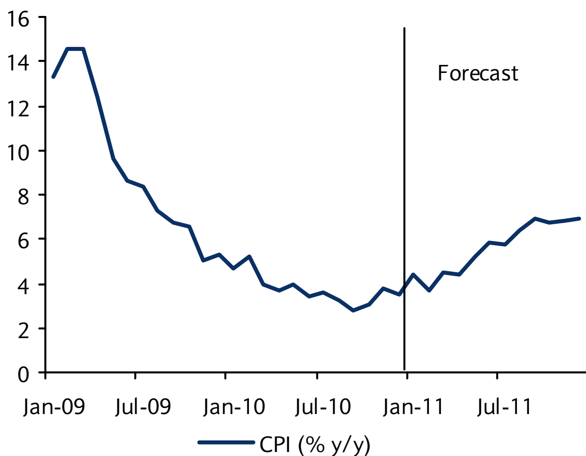
The accommodative monetary policy stance is likely to be continued to support the nascent recovery. The Central Bank of Kenya's (CBK) left the policy rate unchanged for a second consecutive time at its November meeting. The inflation environment remains positive, coming in at 3.8% y/y in November, although we believe higher anticipated food inflation may push headline inflation higher next year to more than 7% by the end of 2011. The outlook for the currency is also upbeat as the risk of meaningful currency depreciation appears limited given the positive external position. Assuming the global recovery regains momentum and the current problems in Europe are short term in nature, we expect increased private capital inflows, tourism, and export revenues to buoy the shilling, although the CBK's interventionist strategy may keep the shilling close to 80/USD. Following the upgrade of the country's rating by S&P, the government has indicated it may issue its maiden USD500mn Eurobond by mid-2011, which may also be KES supportive.

Improving macro picture

S&P recently upgraded Kenya's credit rating

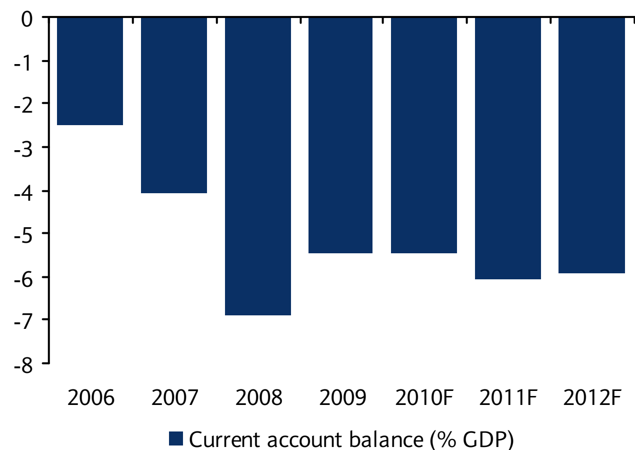
Kenya's medium-term political risk has largely abated following the peaceful referendum in August, when voters adopted a new constitution for the country. In response to the improved political situation and outlook, S&P recently upgraded Kenya's credit rating to B+ (outlook stable) from B. At the end of August, the improving political and economic environment also led Fitch to reaffirm Kenya's B+ long-term rating with a stable outlook.

Figure 1: Inflation to rise steadily in 2011



Source: KNBS, CBK, Absa Capital

Figure 2: Current account to widen marginally



Source: CBK, Absa Capital

GDP outlook is positive, although some sectors continue to struggle

Kenya recorded real GDP growth of 5.1% y/y in H1 10, driven largely by a strong performance by the agricultural, manufacturing, and the trading sectors. The agriculture sector, which contributes nearly 24% to overall GDP, was boosted by good rainfalls and the outlook for next year remains promising. Similarly, tourism improved markedly this year (17% higher on a y/y basis in the first seven months of 2010), which bodes well for the sector's recovery in 2011. Moreover, continued investment in infrastructure and substantial policy support will also be supportive in 2011. Some sub-sectors within the services sector continue to struggle, although we believe the improving operating environment will eventually spill over to these sectors, too. Overall, we expect economic growth to strengthen from our estimated 4.4% in 2010 to more than 5% in 2011.

Recovery not without potential headwinds

The current account faces several risks, mainly from Europe

The current account deficit improved significantly in the year to July, falling to USD1.7bn from USD2.2bn last year. However, the narrowing in the deficit was driven by the services account with the trade deficit deteriorating marginally. The services account was driven by income from tourism, remittances, and transport services, while the deterioration in the trade deficit is a concern as import growth was pushed higher by a large increase in oil imports (23% of total imports). Imports may come under further pressure should global prices of oil and food increase in 2011. In addition, government's infrastructure programme, which is likely to be stepped up next year, will also push up spending for investment goods (28% of total imports). Exports of Kenyan horticulture goods are also sensitive to the economic recovery in Europe, which is the destination of 20% of the country's export goods and which is the origination port for more than 20% of Kenya's tourist arrivals. A stall in the European recovery or a deepening of the current fiscal crisis could therefore have negative consequences for Kenya's external accounts. Nonetheless, we expect the current account deficit to deteriorate to about 6% of GDP in 2011 from our estimated 5% in 2010.

Further loans to expand infrastructure

The Eurobond proceeds and USD500mn ECF loan from the IMF, which has been agreed upon in principle during November, will be used to expand critical infrastructure such as the energy sector. Although the increase in foreign debt is likely to push the country's total debt ratio upwards from the current 51% of GDP (external debt at 22.9%), we do not view debt sustainability as a major concern as yet. Nonetheless, Kenya's government will need to continue with its effort of fiscal consolidation, given its large 6.8% of GDP fiscal deficit projected for the current fiscal year.

Figure 3: Selected macroeconomic forecasts

	2006	2007	2008	2009	2010F	2011F	2012F
Real GDP (% y/y)	6.3	7.0	1.6	2.6	4.4	4.9	5.3
CA (% GDP)	-2.5	-4.1	-6.9	-5.5	-5.5	-6.1	-5.9
Official reserves (USDbn, eop)	2.4	3.4	2.9	3.9	3.8	4.1	4.3
External debt (% GDP)[1]	27.9	23.1	21.6	22.4	22.2	21.7	22.2
Overall fiscal balance (% GDP)[1]	-2.4	-1.2	-3.5	-4.4	-7.0	-6.8	-5.0
CPI (% y/y, eop)	15.6	12.0	27.7	5.3	3.5	6.9	8.9
Currency per USD (eop)	69.40	62.68	77.71	75.43	80.00	81.30	82.50
Benchmark policy rate (%, eop)	10.00	8.75	8.50	7.00	6.00	6.50	7.75

Note: 1) Fiscal year to 30 June.
Source: CBK, NBS, IMF-IFS, Absa Capital

EMEA: LEBANON

Waiting for Bellemare

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The imminent decision by the Special Tribunal for Lebanon (STL) led to a paralysis of government, heightened political tensions and mounting uncertainty. However, economic and fiscal indicators are improving. Moreover, ample reserves and banking sector liquidity constitute large enough buffers to withstand another prolonged political deadlock. We maintain our Market Weight stance.

Strategy:
Market weight on credit

Strategy: Lebanon's credit spreads are already compressed, and we do not expect structural drivers to emerge next year to push up perceptions of credit worthiness and push down spreads. At the same time, we do not expect the current political deadlock due to the STL indictment to affect the credit significantly. In H1 11, we expect Lebanon's government to undertake a debt exchange to rollover about USD3bn of Eurobond maturities. It could possibly issue more should a political consensus emerge soon enough to allow for the finalisation of a draft budget and its ratification by Parliament before mid year (Figure 1), an unlikely scenario, we believe. Balancing the limited upside in spreads and the (geopolitical) risks with the diversification Lebanon credit offers in a global EM credit portfolio context, we maintain our Market Weight stance.

Imminent Special Tribunal indictment heightens political risks

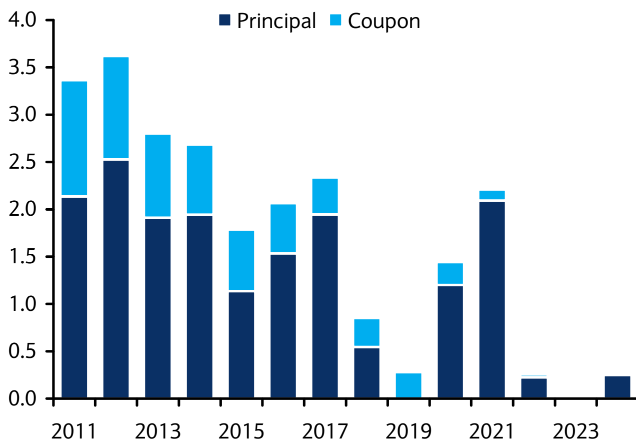
The STL indictment could be issued before year end

As we expected in the September *Emerging Markets Quarterly*, political tension in Lebanon has escalated during the past three months due to an imminent decision by Daniel Bellemare, the Prosecutor for the Special Tribunal for Lebanon (STL), who indicated he would likely file an indictment for the killing of Lebanese Prime Minister Rafik Harriri before year end. According to media and intelligence reports[3], Bellemare could indict members of the Shia Hezbollah party.

8 March movement warned against the STL

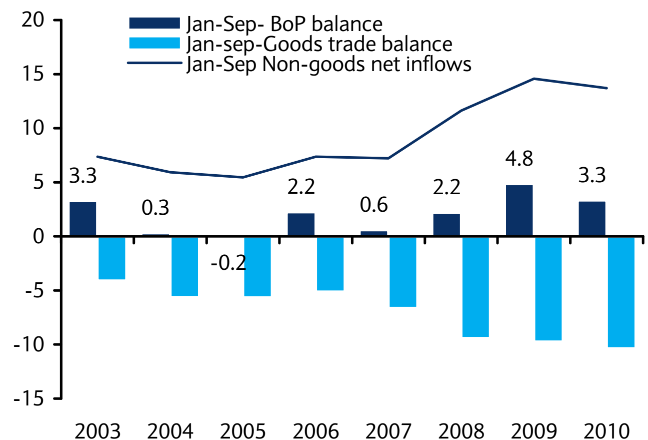
Hezbollah and its allies in the 8 March movement (Shia Amal movement, Christian party of General Michel Aoun and other factions that are allies of Syria) were joined recently by Druze leader Walid Jumblatt and called on Prime Minister Saad Harriri to officially discredit

Figure 1: Lebanon to rollover US3bn of Eurobonds in 2011



Source: Ministry of Finance, Barclays Capital

Figure 2: Balance of payment remains in surplus



Source: Banque du Liban, Haver Analytics, Barclays Capital

[3] This type information was reported in the BBC news, local Lebanese newspapers, Der Speigel magazine.

the STL and refuse the recognition of its upcoming announcements and findings. They believe the STL is manipulated by the US and Israel so as to bring Hezbollah's leadership to international trial, and warned that an STL indictment could jeopardise political stability, bringing to mind the events of May 2008. While theoretically Hezbollah has the military power to impose a solution with its allies, we do not think they will use force given the risks of igniting religious strife and incurring a huge loss to their reputation.

Harriri faces a difficult dilemma

At the same time, Harriri's room to manoeuvre is also limited as responding to his opponents' demands could undermine his credibility with supporters and allies domestically and internationally. Backing away from the STL could also jeopardise Harriri's political standing and future as a Sunni leader, possibly encouraging independent acts of revenge by extremist factions. While his resignation is theoretically an option, we do not think that Saudi Arabia, Hariri's ally, supports this scenario. King Abdullah and President Assad have been trying to come to terms on a compromise. We believe the Syrians prefer (and have tacitly agreed with the Saudis) to ensure that any agreed compromise on the STL be reached and endorsed under Harriri's leadership. Other potential Sunni candidates for premiership, including those politically aligned with Syria, are likely to refuse responsibility for this delicate task as it could undermine their standing within Sunni circles.

Positions are unreconciled…

… and regional efforts to find a solution are still unclear

Over the past month, the Council of Ministers has not convened and participants to the National Dialogue roundtable that the President called for never met, thus blocking all formal avenues of exchange and decision making. While positions remain unreconciled, efforts by regional and international powers are underway and many are banking on the success of the coordinated Saudi-Syrian effort to engage the opposing parties, avoid any escalation and agree on a compromise. It is unclear whether such efforts are coming to fruition, however, as the setback in King Abdullah's health and preoccupation of the Saudi leadership with succession issues may have caused those bilateral efforts to lose steam, further heightening uncertainty on the outlook.

Economic activity remains favourable despite market nervousness

Nervousness took its way to the FX market for a short bout

Against the above set-up, and as the political discourse escalated, weakness in the FX market and stronger demand for USD in October prompted the Banque du Liban (BdL) to intervene in favour of the currency for the first time in two years. While the LBP traded close to 1514/USD, these instances were small and short-lived. Moreover, Lebanese pound-denominated deposit growth continued, bringing deposit dollarisation to 62.6% in September, compared with 64.5% at end-December 2009.

BoP cumulative surplus reached USD3.3bn

In fact, the balance of payments (BoP) continued to record a surplus over the past four months despite slower capital inflows. While a positive services balance and higher remittances are expected to partially cover the trade deficit, the latter remains large and will likely keep the current account at about 10% of GDP in 2010 (the World Bank's most recent estimates of worker remittances was USD8.2bn, up almost 8% from 2009). FDI inflows, notably in the real estate sector, as well as moderate portfolio flows bolstered by a recent USD750mn Eurobond issue and the continued rise of non-resident deposits (USD1.5bn), also contributed to a cumulative BoP surplus of USD3.3bn, compared with USD4.8bn in 2009 (Figure 2). As such, FX reserves continued to increase, reaching USD32bn at end-September. We expected the surplus to trend downwards, given the exceptional amount of transfers from Lebanese living abroad during last year's financial crisis as they sought safe havens in Lebanese banks.

Economic activity maintained its momentum

Credit growth expanded 19% y/y

Moreover, various indicators of economic activity point to continued strong domestic demand during the first nine months of the year, led by the retail, tourism, construction and real estate sectors. Construction permits, cement deliveries and property sales transactions increased 43%, 5% and 25% y/y, respectively during the first nine months of 2010, while the number of tourists rose 18% y/y. Cleared cheques, a proxy for retail transaction, picked up 26% y/y. Consumption and investment activities were supported by increased financing from the local banks, which expanded their lending portfolio 19.2% y/y in 2010. The majority of newly extended credit went to finance real estate, retail and tourism-related projects. The coincident indicator, a composite index of the above that tracks GDP closely, also continued to grow, though at a slower pace – 11.6% compared with 13.2% y/y during the same period in 2009 (Figure 3). Finally, goods export growth picked up 23% y/y through September driven by growing exports of jewellery, electrical equipments and agricultural and food products. Base effects notwithstanding export growth outweighed import growth (10% y/y), reducing Lebanon's large trade balance almost 6.5%.

Reduced transfers to EdL led to lowering the deficit 33%y/y…

… but these remain persistently high

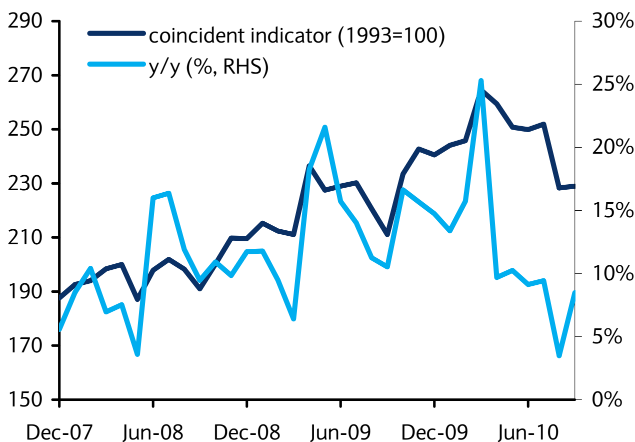
Fiscal performance over the past ten months also exhibited positive results – a 13.2% y/y reduction in expenditure, driven by shrinking transfers from the Treasury to Electricite du Liban (EdL), more than offset the 2.8% y/y decline in revenues, causing the overall deficit to reduce by a third (33% y/y) and an 9.5% increase in the primary surplus (Figure 4). With such results, we estimate that at least a 7pp reduction in debt to GDP would be possible, bringing the debt ratio to an estimated 141% of GDP by end December, down from 148% at end 2009. The fiscal outturns, highlight the persistence of a significant structural problem, namely an estimated fiscal deficit of c.8.5% of GDP, even without accounting for capital spending that would normally be allowed had the budget been ratified.

Outlook and scenarios: the need for an agreement

Without a functioning government, the outlook may get complicated

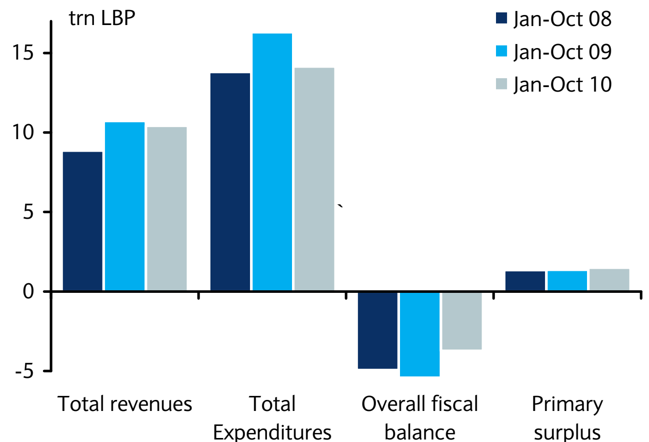
Reducing debt and narrowing the fiscal deficit remain the key challenges in 2011 and beyond for Lebanon and will depend on the country's ability to sustain high levels of economic growth and implement much-needed fiscal and economic reforms. This, in turn, will require a functional cohesive government able to formulate policies and execute decisions to that end. Obviously, the current government is unable to do so until the represented factions agree on a common approach to handle the imminent STL indictment once issued, and on a joint strategy with which Lebanon's formal institutions will deal with the STL and the international community thereafter.

Figure 3: Economic activity is upbeat yet slowing



Source: Banque du Liban, Haver Analytics, Barclays Capital

Figure 4: Fiscal performance is showing some improvement



Source: Ministry of Finance Analytics, Barclays Capital

Our base case scenario is one where an agreement is reached

Our base case scenario is that an agreement among the various factions will be reached, brokered by joint Saudi-Syrian efforts in cooperation with the US, France and Iran. The timing of such an agreement, however, remains elusive. We think all parties recognise the implications of no accord for the country's security and political stability; therefore, there is incentive to reach an agreement as soon as possible. Under such scenario, we look for growth to remain 6-7%, mainly driven by domestic demand fuelled by higher remittances and tourism revenues primarily from the GCC. A delayed budgetary process will not allow for significant capital spending and therefore keep the fiscal deficit flat, which could bring debt-to-GDP downwards slightly to 136% of GDP.

In the worst case scenario, BdL can accommodate pressure on the LBP

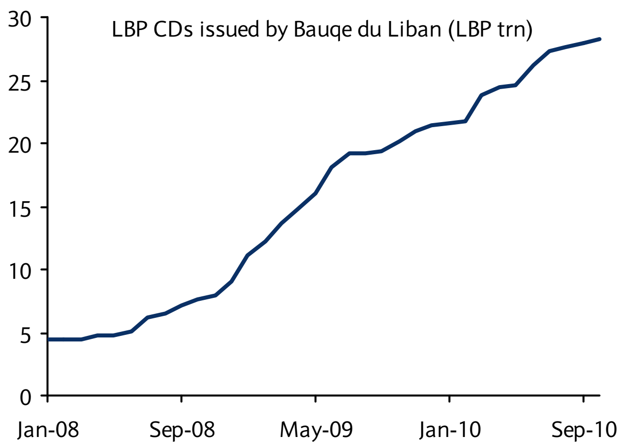
It has significant reserves, and…

The worst case scenario is one in which the Saudi-Syrian efforts do not yield results or that the STL's decision is issued before an agreement is reached. In this case, we would expect ministers of the March 8 movement to withdraw from the National Unity Government, bringing public institutions to a complete halt, this time officially. Under such a scenario, we would expect some renewed pressure in the FX market as in 2006-07, bringing the BdL to draw on some of its reserves. However, in our view, this is likely to be short-lived and limited in scope. The BdL governor has repeatedly confirmed its ability and willingness to ward off any pressure on the LBP and has taken measures to absorb banks' excess liquidity, including primarily through the issuance of Certificates of Deposit (Figure 5), which totaled USD18.8bn at end-October 2010.

….the banking system has ample liquidity

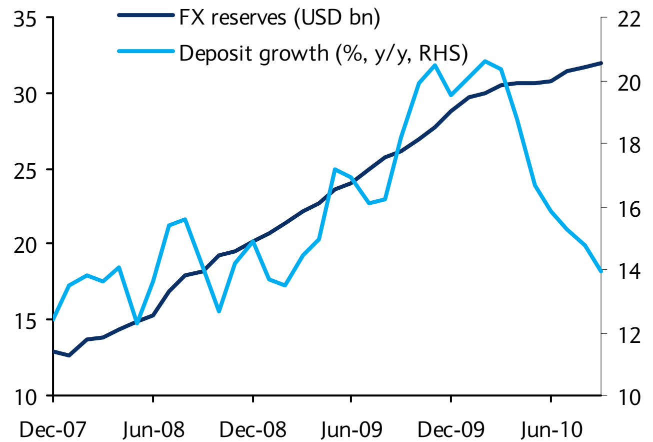
We believe the BdL can easily accommodate further pressures should they recur. Its reserves, at USD32bn amount to more than 55% of short-term debts and cover almost 72% of the country's money supply, putting the country in a much better position than in previous instances of extreme political tension (eg, PM Harriri assassination in 2005, July 2006 war) (Figure 6). Moreover, the banking sector remains solid and amply liquid with the loans to deposit ratio standing at 35% and capital adequacy standing at 13.7%, rendering it able to support imminent financing needs in the public and the private sectors (primary liquidity in FX hovers at about 50% of FC deposits). While the latest results point to some erosion of banks' interest margins due to declining rates on Lebanese debt over the past year, total assets continue to grow and have reached almost 326% of GDP. Deposit growth from residents and non residents continued, though at a slower pace, averaging 8-10% y/y over the past nine months. This compares with 20% y/y in 2009, starting then from a much lower deposit base (Figure 6).

Figure 5: BdL has been absorbing the liquidity of banks by issuing CDs



Source: Banque du Liban, Haver Analytics, Barclays Capital

Figure 6: BDL FX reserves and bank deposit growth



Source: Banque du Liban, Haver Analytics, Barclays Capital

Figure 7: Key macroeconomic indicators, 2007-12

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	7.5	9.3	9.0	7.5	6.5	6.0
CPI (% average)	4.1	10.8	1.2	4.0	4.5	3.0
GDP (USD bn)	25.1	29.9	34.5	38.9	42.8	46.4
FX, eop	1507.5	1507.5	1507.5	1507.5	1507.5	1507.5
External sector						
Current account (USD bn)	-1.7	-2.8	-3.3	-3.9	-4.3	-4.5
CA (% GDP)	-6.8	-9.3	-9.5	-10.1	-10.0	-9.6
Gross external debt (% of GDP)[1]	194	172.7	170.9	162.0	163.4	168.1
Foreign currency external debt (% of GDP)	81.1	70.9	61.7	54.2	48.6	46.3
International reserves (USD bn)[2]	12.9	20.2	29.1	32.1	34.5	36.7
Public sector						
Public sector balance (% GDP)	-10.2	-9.8	-8.6	-7.9	-7.7	-7.5
Primary balance (including grants) (% GDP)	1.6	2.0	3.1	2.5	2.3	3.2
Gross public debt (USD bn)	42.0	47.0	51.1	54.9	58.0	60.0
Gross public debt (% GDP)	167.7	157.2	148.1	141.2	135.4	129.3

Note: [1]Includes all banking deposits held by non-residents, including estimated deposits of Lebanese nationals living abroad but classified as residents.
[2]Total gross reserves including gold. The national valuation of the latter amounts to about USD10bn as at March 2010.
Source: IMF, MoF, BDL, Haver Analytics, Byblos Bank, Barclays Capital

EMEA: NIGERIA

Calm before the storm?

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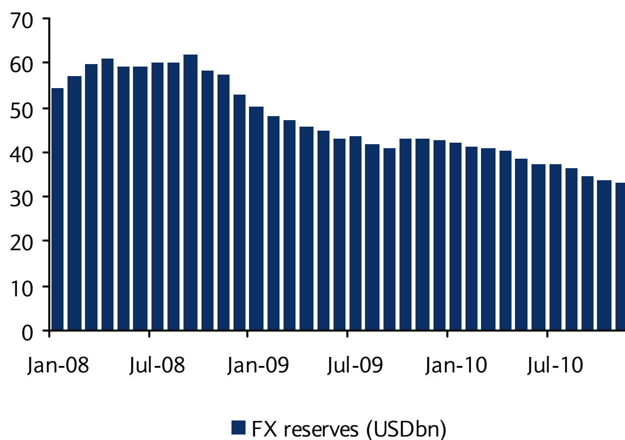
Nigeria's security situation in the oil-producing region is deteriorating amid an increasingly uncertain political backdrop. We expect regional, ethnic and religious tensions to rise ahead of the April 2011 elections, which could affect investor sentiment negatively. Meanwhile, the economic growth outlook remains promising, in our view, despite continued concerns about fiscal spending and oil disruptions. Inflation is still in double-digit territory and as a result, we expect further policy tightening in H1 10.

Political manoeuvring has started

The political and security situations have deteriorated in recent weeks

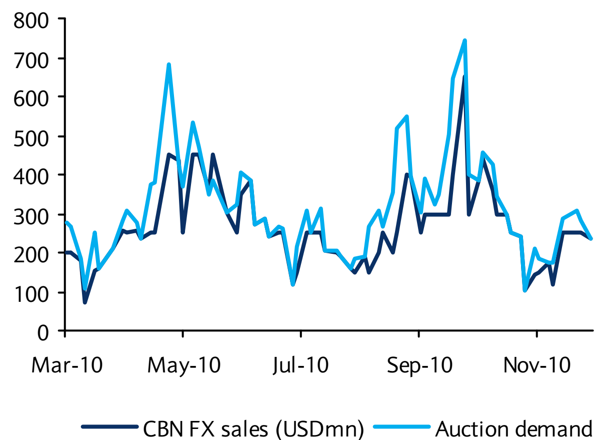
Nigeria's political and security situations remain a concern prior to the April 2011 elections. Deep rifts are developing within the ruling PDP as a result of the zoning agreement. The PDP's candidacy will be contested by two main candidates – President Jonathan (a Southerner) and Atiku Abubakar (a Muslim Northerner) – at its primaries, which are expected to take place in January 2011 at the earliest. While former military ruler Ibrahim Babangida was also considered an early frontrunner for the PDP's candidacy, it emerged in mid-November that an influential group called The Northern Political Leaders Forum (NPLF) had picked former vice president Abubakar (1999-2007) ahead of Babangida and two other candidates. The NPLF's biggest challenge now is to consolidate support behind Abubakar, which includes deciding on a running mate. Abubakar's participation in the PDP primaries is, however, being questioned by some party members after he quit the PDP in 2007 and rejoined in 2009 and then received a waiver from the PDP to contest in the elections. We believe this is likely to give the edge to Jonathan. The PDP primaries are key as its candidate is usually a strong contender at presidential elections, given the apparent lack of credible opposition parties. Internal bickering within the PDP is, however, positive for opposition parties, although we believe the PDP will retain its dominance in the legislative elections. More broadly, we believe the continuing divisions within the PDP and the risk of poorly managing the primaries could exacerbate regional, religious and ethnic tensions. Nigeria has a history of violence during elections, and the government will be under pressure to provide the appropriate conditions for an election to be held. Local experts have also publically

Figure 1: FX reserves falling amid rise in FX demand



Source: CBN

Figure 2: FX demand still outstrips supply



Source: CBN, Absa Capital

criticised the electoral committee, claiming that it has fallen behind with preparations that may affect negatively on a free, fair and transparent election process.

The violence in the Niger Delta is disrupting oil production

Outside the specific concerns about the election period, the situation in the Niger Delta also continues to deteriorate following a surge in violence and attacks on oil infrastructure. Militants appear to be frustrated about government's slow response to develop the region, which lacks basic infrastructure. Not only will the increase in violence disrupt oil production, but it is likely to hurt President Jonathan's campaign as he is an ethnic Ijaw from the Niger Delta, yet he appears unable to improve security in the region. Further violence will result in lower oil production as was demonstrated by recent attacks on a supply pipeline that resulted in production cuts of 100,000-200,000bpd (5-10% of output).

Increased country risk is likely to be negative for Nigerian financial markets

The disruption in oil production and revenues and the deterioration in the country's risk profile may negatively affect financial markets, with the currency particularly vulnerable. The naira depreciated 3% against the USD at the end of Q3 10 for several reasons, including seasonal corporate payments, while it appeared that there was also an element of investor uncertainty shortly before the planned PDP primaries, originally scheduled for October 2010. Subsequently, the naira has returned to the Central Bank of Nigeria's (CBN) preferred level of USD/NGN150, but further depreciation risk remains substantial. Although FX reserves remain comfortable (about 15 months of import cover) after falling sharply from USD42bn in January to USD33.1bn in November as the CBN intervened to support the naira, the continual decline shows that the market remains under pressure.

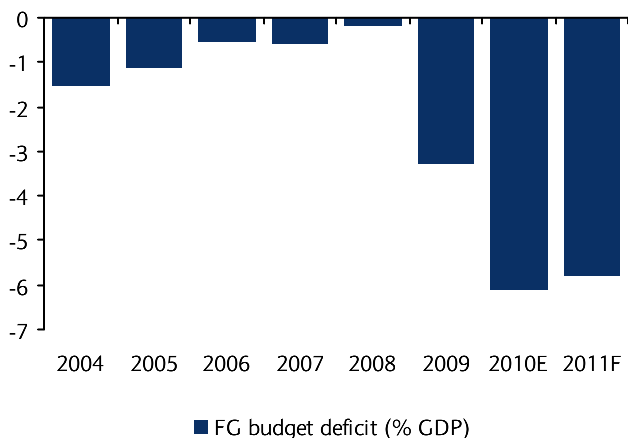
Rating agencies are concerned about the political situation

In October, Fitch Ratings lowered Nigeria's sovereign credit outlook to Negative (BB-) from Stable as it was concerned about the heightened political risk, the drop in FX reserves and the depletion of oil savings. In contrast, S&P affirmed Nigeria's rating as 'B+' with a Stable outlook a week later, citing a strong external and fiscal balance sheet and noting that it expects a better budgetary performance ahead. S&P acknowledged that the increase in political risk has constrained the rating.

The fiscal situation may improve if the government can contain excessive fiscal spending

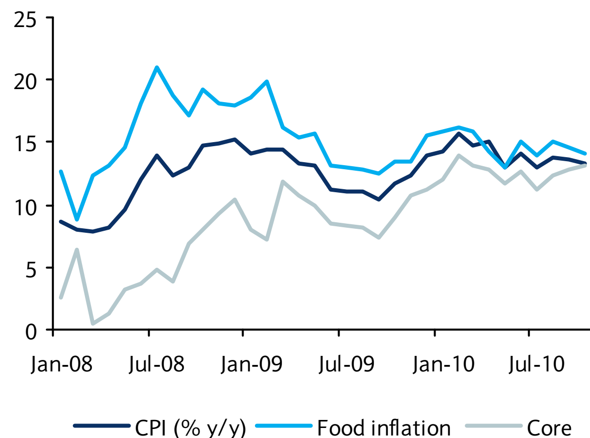
Nigeria's fiscal spending remains a concern to us as the federal government appears unable to contain spending, having depleted the oil savings in 2010 and increased its borrowing in the domestic market. As a result, the 2010 fiscal deficit deteriorated to 6.1% of GDP from 3.3% in 2009, missing its target of 4.8%. This occurred despite a marked increase in oil revenues for the government (over 80% of fiscal revenues are derived from oil) after a 27%

Figure 3: Fiscal situation likely to improve marginally in 2011



Source: CBN, Absa Capital

Figure 4: Inflation outlook cloudy



Source: CBN,NBS, Absa Capital

increase in the average price of oil in 2010 compared with 2009 and higher average oil production. In 2011, the government promised to rein in spending, and we anticipate a deficit of marginally below 6% of GDP. The IMF, following the completion of its mission in November, supported the government's plan to reduce the deficit in 2011-13 and recommended that spending be reallocated from recurrent to capital projects to support economic growth. Nigeria's total debt ratio remains low at 16.5% of GDP.

Getting ready to tighten further

Growth will likely remain brisk in 2011 despite severe capacity constraints

Economic growth has remained buoyant throughout 2010, supported by the non-oil sector, in particular the agriculture, trade and services sectors. The statistical office expects economic growth of 7.9% in 2010, marginally ahead of our expectations. In 2011, we expect Nigeria's substantial capacity constraints, especially the electricity sector, to continue to weigh on its economic potential – the CBN has recently made a renewed call to the government to address 'binding growth constraints' of the economy. Notwithstanding the constraints, we expect economic growth in 2011 to be supported by the non-oil sector, a further strengthening of the oil sector and improved banking sector confidence, which may result in an increase in credit lending. We forecast growth to once again exceed 7% in 2011.

CBN to resume monetary policy tightening in 2011

Assuming crude oil prices remain firm, we believe the current account may record a healthy surplus in 2011. However, Nigeria's inflation environment is less rosy because it remains stubbornly high, at about 13.5%, as a result of high food inflation (food inflation has averaged 15% y/y since the beginning of the year). Coupled with the uncertain outlook for food inflation, the inflation outlook is threatened by currency risk, high inflation expectations, the planned removal of subsidies and excessive fiscal spending. As a result of these upside risks, the MPC increased the policy rate 25bp in September, although it left the policy rate unchanged at its November meeting as it awaits the impact of the previous rate hike to work through the system. As the MPC has indicated that further tightening is needed, we expect further monetary policy tightening during 2011.

Figure 5: Selected macroeconomic forecasts

	2006	2007	2008	2009	2010F	2011F	2012F
Real GDP (% y/y)	6.0	6.4	6.0	7.0	7.7	7.5	7.0
CA (% GDP)	23.7	18.9	15.5	14.0	13.8	13.6	15.0
FX reserves (eop)	42.3	51.3	53.0	42.4	33.0	35.0	38.0
External debt (% GDP)	2.5	2.2	1.8	2.4	2.4	3.8	3.4
FG budget deficit (% GDP)	-0.5	-0.6	-0.2	-3.3	-6.0	-5.8	-5.2
CPI (% y/y, eop)	8.6	6.6	15.1	12.0	11.6	10.4	11.3
Currency per USD (eop)	128	118	138	149	152	153	153
Benchmark policy rate (%, eop)	10.00	9.50	9.75	6.00	6.25	8.50	9.00

Source: IMF, CBN, Absa Capital

EMEA: POLAND

Strong inflows trump weak fiscal policy

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Strategy:
Rates – Pay 5y IRS
FX – Neutral
Credit – Long 10y Poland CDS / short SOAF 5y CDS (DV01-neutral)

Poland's growth has accelerated. Inflation is in the middle of the target range and is rising because of higher food and energy prices. The NBP is clearly leaning towards raising the 3.5% policy rate; we think the rate hike cycle will begin in Q1 2011. The government's fiscal position has been deteriorating and the correction path is uncertain. However, strong balance of payments inflows have allowed the NBP to rapidly build up reserves, despite a widening current account deficit.

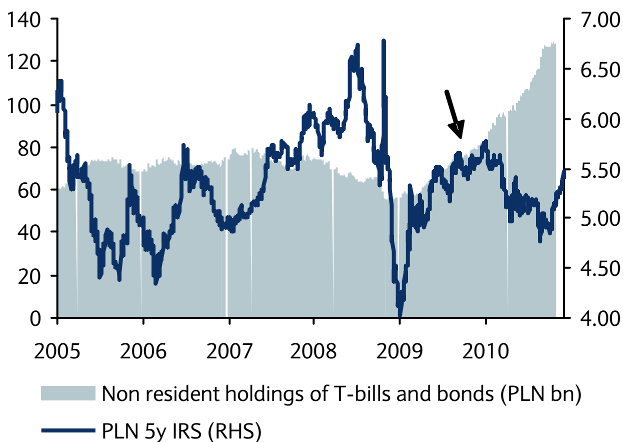
Strategy: We gradually shift to a more cautious stance on Poland. While fundamentals look relatively strong, technical factors have deteriorated and fiscal uncertainties have increased. In our view, current valuations do not compensate investors sufficiently for these risks. In rate space, we see NBP starting to tighten monetary policy in Q1, which is already priced into the short end of the yield curve. Yield compression at the longer end of the curve was directly related to a massive increase in foreign holding of local bonds this year, which is unlikely to be repeated next year (Figure 1). Given the uncertainty attached to fiscal policy and relatively high foreign positioning, we recommend paying 5y rates (c.5.40%) as historically this part of the curve has been the most sensitive to fiscal developments. The carry/roll down cost of holding this position is relatively low (4bp per month). We are taking a neutral stance on PLN FX and expect it to be range bound. PLN risk premium is not attractive given the local demand for FX refinancing. On Poland credit, we take an overall cautious stance. In our view, Poland's lack of commitment to more substantive fiscal adjustments is leaving it vulnerable to contagion effects. We reiterate our long Poland 10y CDS, short SOAF 5y CDS (DV01-neutral) trade recommendation, taking advantage of the relative flatness of Poland's back-end CDS curve.

Growth accelerating

Poland's growth is accelerating on higher consumption and increased production

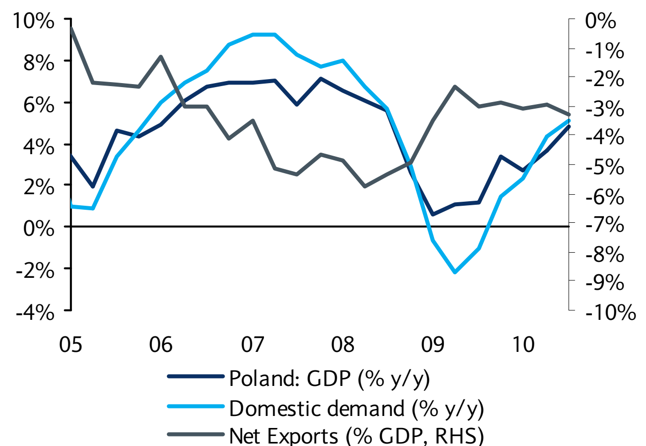
Poland's growth is accelerating as domestic demand has picked up, offsetting a modest drop in net exports (Figure 2). Growth is expanding 4% y/y and moving up more rapidly q/q. Its exports declined in Q3, as in many countries, as the global economy appeared to experience a mid-cycle slowdown. Poland's pickup in domestic consumption helped it to

Figure 1: Polish yields are at risk if FX inflows into government securities merely slow



Source: Bloomberg

Figure 2: Domestic demand taking over from exports



Source: Poland Central Statistics Office, Haver Analytics

Household demand has recovered

avoid a pause in GDP growth. Other indicators support the positive growth view. On the production side, PMI has increased to the highest level since 2004, with output and new orders surging, and industrial production is up strongly. On the consumer side, real retail sales have been climbing and bank lending to households has increased. Similarly, labour markets have improved lately, with total employment regaining pre-2009 levels. However, unemployment remains high at 12%, helping to explain why wages have remained low (Figure 3). Thus, there is still spare capacity in the system, leaving room for further growth acceleration without triggering demand-pull inflation.

Inflation and monetary policy: NBP still on hold

The MPC is moving closer to initiating a rate hike cycle

Inflation at 2.8% is slightly above the middle of the 1.5-3.5% target range and is climbing because of higher food and energy prices (Figure 4). The gap between headline and core is expanding, with core remaining low at 1.2% (during 2005-10, the gap between headline and core was 1.1pp). NBP management appears to believe that core is a better guide for monetary policy than headline. Thus, at this point, the NBP has kept its 3.5% policy rate on hold while signalling a tightening bias by raising reserve requirements. The MPC expects to raise rates at some point, but sees advantages in delaying rate hikes due to concern about capital inflows, durability of global growth and rising FX-denominated mortgage lending. The faster pace of growth and currency weakness are factors that would encourage sooner rate hikes.

We expect rate increases to commence in Q1 11

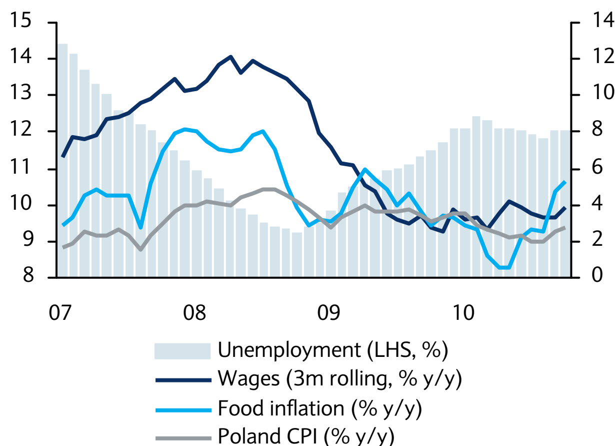
Our modified Taylor rule analysis indicates that a rate hike is not yet justified under the current conditions, using either headline or core inflation as the guide. However, as headline inflation and growth accelerate, the MPC will likely move closer to rate hikes. We predict the NBP will remain on hold until Q1 11.

Fiscal stance deteriorating

High budget deficits are causing government debt to rise

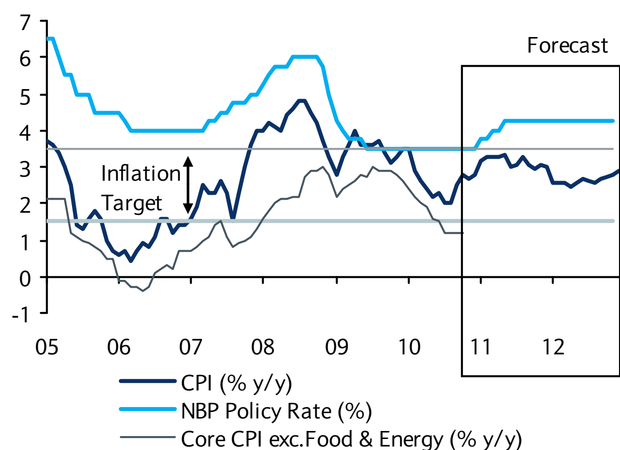
Poland's fiscal stance has deteriorated during the past two years, when the government has allowed deficits to exceed 7% of GDP per annum, and public debt levels have risen to 55% of GDP (using EC ESA95 definitions). With debt levels approaching Maastricht limits, Poland's very high budget deficit is leading to a build-up in government debt. While Polish government debt is below the euro area average of 80% of GDP, its deficit is above the euro area average (ie, 6% of GDP).

Figure 3: Food inflation is pulling headline CPI higher, while low wage inflation is keeping core CPI down



Source: Poland Central Statistics Office, Haver Analytics

Figure 4: A gap is developing between headline and core inflation



Source: National Bank of Poland, Poland Central Statistics Office, Haver Analytics

Poland is subject to EC Excessive Deficit Procedures and is trying to prevent government debt from crossing above 55% of GDP

Poland is under pressure from the EC Excessive Deficit Procedures to cut deficits. In addition, it has its own domestic fiscal responsibility legislation, with mild sanctions when government debt crosses 50% of GDP, but much more stringent sanctions at 55%, and constitutional limits on incurring further deficits when debt crosses 60% of GDP. The government plans to bring the 2011 budget deficit down to 6.5% of GDP from an estimated 8% in 2010 by raising the VAT rate by 1% and limiting early retirement. In addition, with privatization and consolidation of public sector accounts (cutting debt by 1.5% of GDP), the government expects to keep its debt just below 55% at end-2011 (using its slightly modified definition, Figure 5). Any slippage will push it over the threshold, in which case preannounced contingency measures would be activated.

The government appears reluctant to tighten fiscal policy and instead is opting to change debt and deficit definitions

With debt bumping against the thresholds, the government is faced with a choice of either enacting fiscal adjustment or making cosmetic changes to the definitions of debt and deficits to stay under the 55% threshold. It has been reported in the press that the government has decided to make modifications to pension reforms that will slightly lower recorded deficit and debt. Currently, the government pays about 1.5pp of GDP per annum to private pension funds for future pension payments. The government has decided to cut these payments back by one-third and to temporarily make the payments in the form of non-tradable 'pension bonds' that will not be counted in the Polish definition of government debt. The decrease in payments will have only slightly negative consequences for the long-term sustainability of the pension system. The government is clearly trying to preserve its second pillar reforms, while at the same time creating more room for deficits. There is some upside risk that the government might cause an early parliamentary election in 2011 that could enable fiscal adjustments to be put in place sooner.

Balance of payments

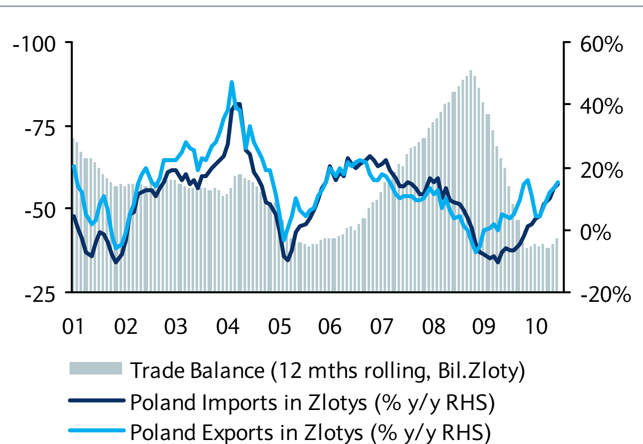
Poland's balance of payments is in a very strong position

Poland's balance of payments are strong, with the relatively small current account deficit of 2.5% of GDP (about €10bn) well financed by portfolio inflows, FDI and loans. During 2009 and 2010, the NBP has accumulated about €15bn per annum, bringing total reserves to €72bn. Reserves now provide adequate coverage of current account balance flows and short-term debt. The current account deficit declined during the global recession on improvements in the terms of trade and a drop in Poland's imports (Figure 6).

Figure 5: Government debt levels approaching 55% of GDP threshold

Source: Poland Central Statistics Office, Haver Analytics

Figure 6: Trade deficit is at historical lows, but climbing



Source: Poland Ministry of Finance, Haver Analytics

The current account improved in the past two years and the NBP has been accumulating reserves at a rapid rate

There are some undercurrents of Poland's balance of payments that worry us. Large errors and omissions persist that we think represent refinancing needs of local banks and corporations undergoing deleveraging. While this has been easily covered by BoP financing, the continued large errors and omissions could become burdensome if portfolio inflows dry up. In addition, during the past quarter there was some deterioration in the current account as the trade deficit widened (partly on a low base), income outflows increased and current transfers declined. There is a risk that the CA will deteriorate further as growth accelerates.

The exchange rate is competitive

In our analysis and based on IMF papers, the exchange rate appears to be at fair value in the range of PLN3.8/€, or perhaps lower. At current levels, the exchange rate is quite competitive, as indicated by the strong exports performance and the increase in international reserves. Nevertheless, there has been pressure on the currency, reflecting in our view, investors' nervousness regarding peripheral euro area countries, Poland's weak fiscal stance and strong bank demand for FX to cover its FX-denominated loans.

Figure 7: Poland macroeconomic forecasts

Poland	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.8	4.9	1.6	3.8	4.0	4.3
Domestic demand contribution (pp)	9.4	5.8	-0.6	4.2	4.2	4.4
Private consumption (% y/y)	5.3	5.4	2.0	3.0	4.0	4.1
Fixed capital investment (% y/y)	24.3	3.8	-13.9	5.4	9.7	7.2
Net exports contribution (pp)	-2.6	-0.9	2.2	-0.3	-0.2	-0.1
Exports (% y/y)	9.1	7.2	-8.6	10.6	7.9	8.6
Imports (% y/y)	13.7	8.5	-12.6	10.7	7.7	8.2
GDP (USD bn)	425	533	435	491	537	576
External sector						
Current account (USD bn)	-19.9	-25.3	-9.8	-14.7	-16.4	-18.4
CA (% GDP)	-4.7	-4.7	-2.3	-3.0	-3.0	-3.1
Trade balance (goods and services) USD bn)	-16.9	-25.9	-4.2	-7.0	-9.0	-9.0
Net FDI (USD bn)	18.0	10.3	9.3	10.3	11.3	12.5
Other net inflows (USD bn)	25.8	35.6	33.9	38.5	25.7	24.5
Gross external debt (USD bn)	234	245	281	309	340	374
International reserves (USD bn)	66	62	80	97	107	116
Public sector						
Public sector balance (% GDP)	-2.0	-3.9	-7.5	-7.9	-6.5	-6.0
Primary balance (% GDP)	0.1	-1.8	-5.0	-5.4	-4.0	-3.5
Gross public debt (% GDP)	45.0	47.2	51.0	54.7	55.8	56.2
Prices						
CPI (% Dec/Dec)	4.2	3.3	3.5	2.8	3.0	2.9
EUR/PLN, eop	3.60	4.15	4.10	4.00	3.90	3.80
	1y ago	**Last**	**Q4 10F**	**Q1 11F**	**Q2 11F**	**Q3 11F**
Real GDP (y/y)	1.8	3.2	2.6	4.0	2.9	3.6
CPI (% y/y, eop)	3.3	2.8	2.8	3.3	3.0	3.0
Exchange rate (eop)	4.21	3.90	4.00	4.00	3.90	3.90
NBP policy rate (%, eop)	3.50	3.50	3.50	3.75	4.00	4.25
Market implied rate (%, eop)			3.75	4.25	4.50	4.75

Source: National Bank of Poland, Ministry of Finance, Central Statistics Office, Haver Analytics, Barclays Capital

EMEA: ROMANIA

Fiscal adjustments, improving outlook

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Romania's economy is still stuck in recession. Widening fiscal deficits led to increases in government borrowing and fiscal dominance of financial markets, which crowded out private sector activity, harmed confidence and limited the flexibility of monetary policy. With the radical fiscal adjustments implemented in mid-2010, the government is trying to break the downward spiral. By keeping these measures in place during 2011, the fiscal deficit should decline and begin to form the basis of an economic recovery. We think the government will be able to overcome fierce opposition and lack of public support for fiscal adjustment and succeed in implementing fiscal improvements.

Strategy:
Credit - Short Romania 5y CDS versus long Croatia 5y CDS
Rates – Fund long 6m T-bills from 1m FX implied RON

Strategy: Given Romania's commitment to fiscal adjustments under the IMF programme, we had taken a constructive stance on Romania credit versus peers in the region (*Romania trip notes*, 23 November 2010). While some political uncertainties remain and the Eurobond supply for next year may provide some headwinds, we continue to see value in Romania credit at current levels on a relative value basis. We express this view via a short Romania 5y CDS versus long Croatia 5y CDS trade recommendation. Against the backdrop of Croatia's increasing risks and challenges and Romania's improving outlook, we expect the two countries' CDS spreads to re-converge (Figure 1). In local rates, we see opportunity for an RV trade and recommend buying 6m T-bills (1y are illiquid and difficult to source) funding out of 1m FX implied RON. The curve is very steep at the front end, given the excess liquidity in the system. 6m T-bill yield are about 6.5%, versus 1m FX implied RON rates of about 3%, implying annualized carry/roll of 350bp from the RV trade. For non-cash investors, the funding costs will be about 100-150bp higher, which reduces the spread on the trade to about 200bp. The main risk to the trade is the volatility in the financing costs, but this tends to be greatest on more short tenor RON rates (o/n and weekly). In FX, RON remains unappealing to us, so we avoid exposure.

Growth challenged because of delayed fiscal adjustment

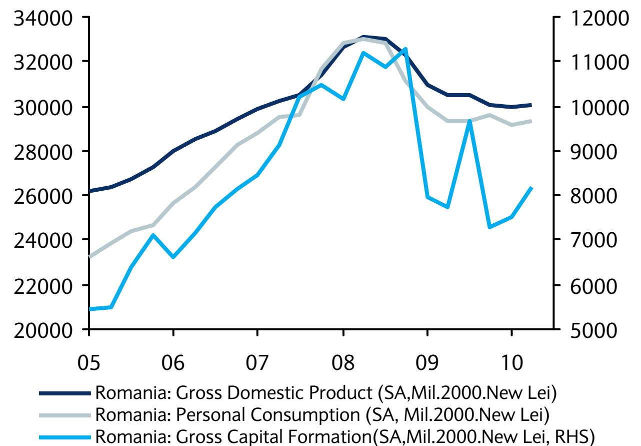
Real GDP has declined 10% and is still falling

Romania's economy is still unable to sustain positive growth as GDP has plummeted a cumulative 10% during the past 2 ½ years (Figure 2). Private consumption has fallen

Figure 1: We expect Croatia, Romania CDS to re-converge

Source: Romania Institute of Statistics and Economic Studies, Haver Analytics

Figure 2: GDP is still declining on low domestic demand



Source: Romania Institute of Statistics and Economic Studies, Haver Analytics

because overall household incomes are down. Employment has declined a cumulative 13%, while average wages have been stagnant in nominal terms. Business investment has been unable to gain traction as industrial turnover has been flat. The only bright spot in the economy has been exports, which have benefited from the solid European demand (Figure 3). Unfortunately, Romania is a case in which weak domestic demand has offset strong external performance.

Romania's ongoing recession is a result of delaying fiscal adjustments

The depth of the decline reflected the highly leveraged position of Romania going into the global recession, with double-digit current account deficits and dependence on short term financing that quickly disappeared when the recession hit. Romania also was highly leveraged due to its fiscal deficits. The inability for the economy to recover is due to delayed fiscal adjustment. Successive governments decided to put off fiscal adjustments.

Radical measures to rebalance the fiscal outlook were needed to facilitate recovery

In our view, the fiscal rebalancing that has been implemented was a necessary condition to put Romania's economy on a sustainable growth path, even though it initially pushes growth down and causes a loss in confidence (Figure 4). We believe the government will implement the fiscal reforms needed to keep on track with the IMF programme (passage of pension reform, uniform wage law and the 2011 budget). At this point, the ruling coalition faces a stark choice. The government is in the process of "taking responsibility" for the main laws, which means there will be another no-confidence vote. The coalition either holds together or the government will be dissolved and early elections become likely. There is clearly a risk that it will not succeed, but the costs will be extremely high. The government's future lies in fully implementing its reforms and relying on rapid economic improvements to prove that the path it chose was necessary and in the longer-run interest of the country.

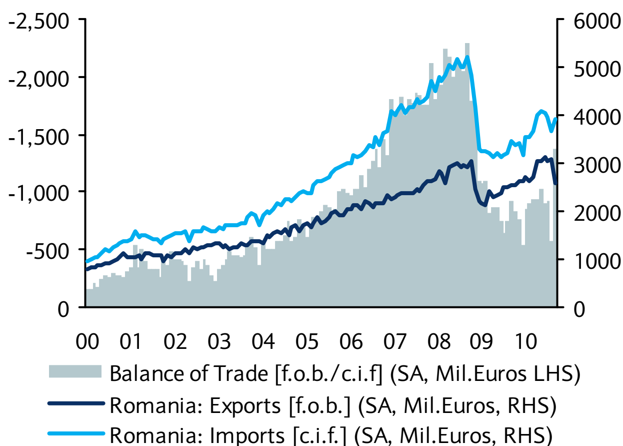
The ruling coalition is likely to implement its economic programme

Because overall public debt is low, fiscal solvency can be restored relatively easily, without the need for onerous primary surpluses. Stable monetary policy provides a favourable financial environment. However, having delayed fiscal adjustment for so long, there is very little wiggle room left for the government to implement adjustments – they have to act now.

We expect return to growth starting H2 11

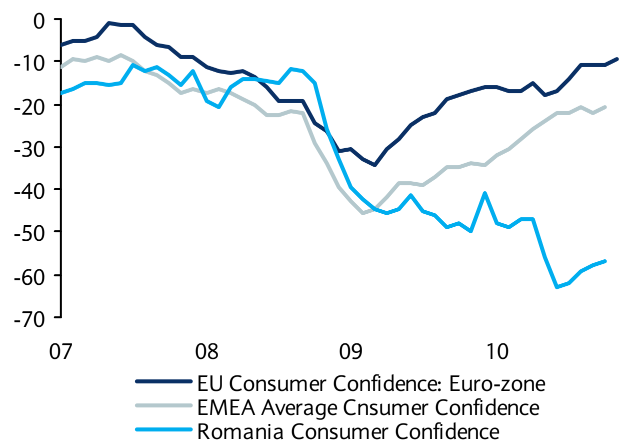
Given the progress in implementing fiscal adjustments registered so far and the likelihood of implementing the 2011 programme, we think growth will stabilize in H1 11 and begin to gain traction in H2 11, averaging 0.4%. We predict growth will accelerate slightly in 2012 to 1.2% y/y as consumption and investment increase off low bases.

Figure 3: Exports have recovered to pre-recession levels



Source: Romania Institute of Statistics and Economic Studies, Haver Analytics

Figure 4: Consumer confidence still depressed



Source: EU, Bloomberg

Fiscal goals for 2011 appear reasonable

The measures implemented in mid-2010 are sufficient to achieve the 2011 budget target

At this time there is relatively little uncertainty regarding the effectiveness of the fiscal measures implemented in July 2010 when the government cut public sector wages 25%, lowered social benefits (other than pensions) 15%, eliminated special pensions and raised the VAT rates 5pp. Fiscal data available for three months (August-October) have shown a remarkable turnaround in the accounts. During H1 10, there was fiscal deterioration as revenue was flat in nominal terms and expenditures increased 4% y/y, causing the fiscal deficit to rise RON3.7bn (0.5% of GDP). So far in H2, there has been an improvement with revenues up 12%, expenditures up 1% in nominal terms, and the deficit lower by RON7.5bn (Figure 5). The measures were estimated to improve the fiscal deficit by more than 2pp of GDP in H2 10. By keeping the same measures in place for all of 2011, they will have twice the impact and therefore help achieve the 4.4% of GDP deficit target. Given that the measures have been so effective in 2010, there is little doubt they will work as well in 2011. During 2009-10, the government missed original budget targets by a wide margin, with deficits of 7.2% in 2009 and an estimated 6.8% in 2010. We expect the more realistic macro assumptions underlying the budget to help it achieve its 2011 targets.

Inflation to decline in mid-2011

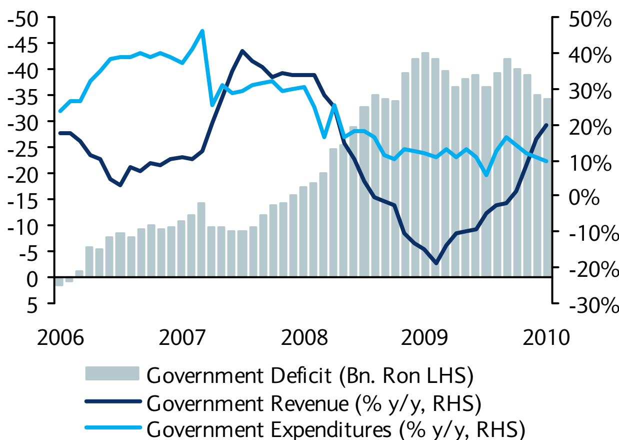
NBR likely to keep policy rate unchanged in 2011 as it announced it will lower its inflation target in 2012-13

Inflation has risen to 8%, well above the inflation target. The 5pp increase in VAT rates is estimated to have added 3pp to inflation, and a 5.5pp increase in food prices caused an additional 2pp increase. Thus, there is minimal pressure from domestic demand on inflation in Romania. The NBR projects that inflation will drop to about 3.5% in mid-2011, and we broadly agree. The policy rate at 6.25% will probably remain unchanged even with inflation set to decline. The NBR recently decided to change its inflation target, cutting 0.5pp each during 2012 and 2013. The new target will be 1.5-3.5% after the changes. We think the NBR will be challenged to try to bring inflation into this new target range and will need to follow a tighter monetary policy path and therefore put off rate cuts.

Balance of payments - improved but not enough to drive RON higher

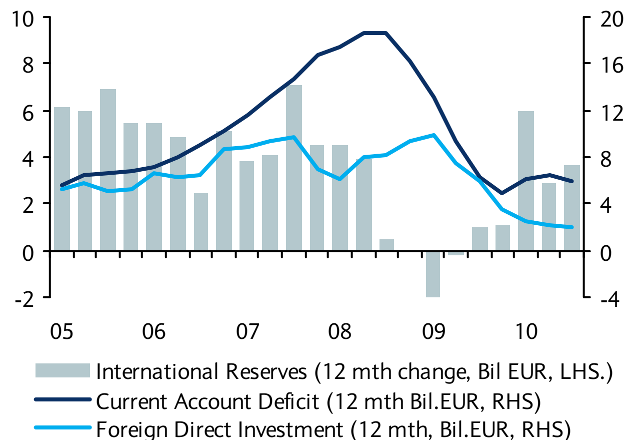
The NBR has been occupied with maintaining the stability of the exchange rate in these difficult times for Romania financial markets. Previously, high current account deficits were financed by private sector borrowing and portfolio inflows. This caused external debt to increase to more than 60% of GDP. With the recession, Romania suffered a sudden stop in

Figure 5: Fiscal fortunes turning better



Source: Ministry of Public Finance, Haver Analytics

Figure 6: Lower current account deficits easily financed



Source: Romania Institute of Statistics and Economic Studies, Haver Analytics

external financing, which caused a large drop in imports that lead to the current account deficit dropping (Figure 6). The CA improvements have helped the NBR keep the exchange rate stable, notwithstanding the large excess liquidity in the banking system. The CA deficit has started to widen moderately, and we expect further widening. As growth gains momentum, there is a risk that CA deficits will widen to unsustainable levels again.

Banks – offering little support for the recovery

Banks are not offering much support to the private sector, with loans to the private sector flat in 2010. Deposits are also flat because of the weak economy. Bank finances are weak, with non-performing loans (NPL) 11.7% of loans and likely to rise further ("substandard" loans are an additional 11% of the total). Bank provisions are substantial, covering two-thirds of NPL, and bank capital adequacy at 15% provides some comfort. Still, banks are not in position to ramp up lending. There is risk from Greek banks ownership of 15% of banking assets. While we do not think a pullout is imminent, gradual drawdown of support is likely to keep the banking system weak.

Figure 7: Romania macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.3	7.3	-7.1	-1.8	0.4	1.2
Domestic demand contribution (pp)	23.2	9.1	-22.1	-0.5	2.0	2.0
Private consumption (% y/y)	11.1	8.5	-8.8	-1.4	0.4	1.5
Fixed capital investment (% y/y)	29.4	18.3	-22.3	-14.3	-1.6	3.4
Net exports contribution (pp)	-16.9	-1.6	15.2	-1.3	-1.6	-0.8
Exports (% y/y)	7.9	7.1	-4.9	17.1	7.4	8.3
Imports (% y/y)	28.2	5.5	-20.2	12.5	6.7	6.3
GDP (USD bn)	169.0	203.6	175.0	185.4	192.9	202.3
External sector						
Current account (USD bn)	-22.9	-24.1	-6.8	-8.5	-8.8	-11.4
CA (% GDP)	-13.6	-11.8	-3.9	-4.6	-4.6	-5.6
Trade balance (USD bn)	-24.7	-28.1	-10.7	-10.2	-12.4	-13.3
Net FDI (USD bn)	9.7	13.8	4.9	3.2	2.7	3.0
Other net inflows (USD bn)	15.2	11.9	3.3	3.3	3.3	3.3
Gross external debt (Eur bn)	66.5	84.0	106.3	112.5	118	122
International reserves (USD bn)	37.2	36.9	40.8	44.5	41.8	36.7
Public sector						
Public sector balance (% GDP)	-2.3	-4.8	-7.2	-6.8	-4.4	-3.5
Primary balance (% GDP)	-1.5	-4.1	-6.3	-5.8	-3.2	-2.3
Gross public debt (% GDP)	12.7	13.3	28.5	35.7	38.7	40.4
Prices						
CPI (% Dec/Dec)	4.9	6.6	4.7	7.9	3.7	3.6
EUR/RON, eop	3.61	3.99	4.23	4.34	4.37	4.43
	1yr Ago	**Last**	**10Q4F**	**11Q1F**	**11Q2F**	**11Q3F**
Real GDP (y/y)	-7.6	-2.2	-0.3	-0.1	-0.2	0.6
CPI (% y/y, eop)	4.9	7.8	7.9	7.1	7.1	4.3
Exchange rate (eop)	4.18	4.27	4.34	4.38	4.35	4.35
Policy rate (%, eop)	9.50	6.25	6.25	6.25	6.25	6.25

Source: National Bank of Romania Ministry of Public Finance, National Institute of Statistics and Economic Studies, Haver Analytics, Barclays Capital

EMEA: RUSSIA

The recovery is cooling off

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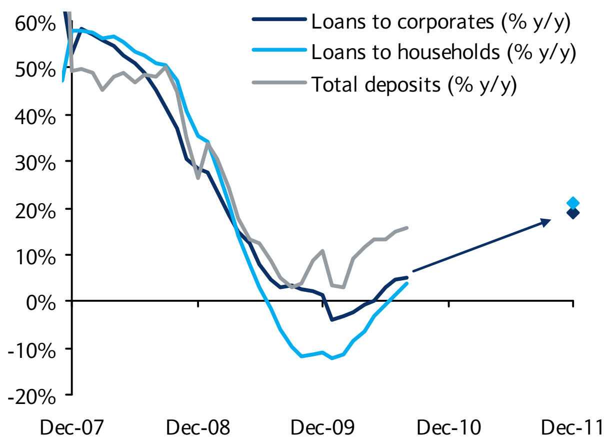
Strategy:
Credit – Market Weight
Local – Window for paying in Q2, trading RUB tactically

Russia's growth trend has shifted down due to the summer heat wave and delayed investment recovery. While the latter has shown signs of vigour in recent months, the effects of the former continue to linger. The moderating external sector's contribution places higher emphasis on domestic demand. We expect this transition to continue but emphasize the risks of weakening consumer demand and, particularly, investment recovery. The volatile nature of external flows has been reflected in the sudden rouble weakening since September. We expect this trend to reverse in Q1 11, as the external debt repayment schedule lightens up. However, a shrinking current account and more 'hands-off' CBR stance may make potential cross-border investment flows even more disruptive.

Strategy: Investors have been uneasy about Russia's long-term growth prospects, fiscal financing needs and capital outflows; in our view, this is understandable. We think these concerns are not likely to be assuaged next year, particularly as we do not expect the global liquidity conditions and the appetite for EM assets to be as strong as in 2010. Our bias is to be paid local rates, and investors should be cautious on the rouble. However, fiscal financing and Russia's BoP tend to have positive seasonal patterns in Q1. Thus, we opt for a neutral stance for now. In credit space, the relative underperformance of Russia over the few past months reflected the above concerns. Continued supply from Russian quasi-sovereigns and corporates has also weighed, and will likely continue to weigh, on sovereign spreads. That said, debt sustainability is not an issue for Russia at this stage. The financing needs will likely be met in the local market and potentially via RUB-denominated global bonds, alleviating supply pressures for credit. Taking into account the current spread premium over other big benchmark credits in EMEA and LatAm, we take a Market Weight stance on Russia in a global EM credit portfolio context.

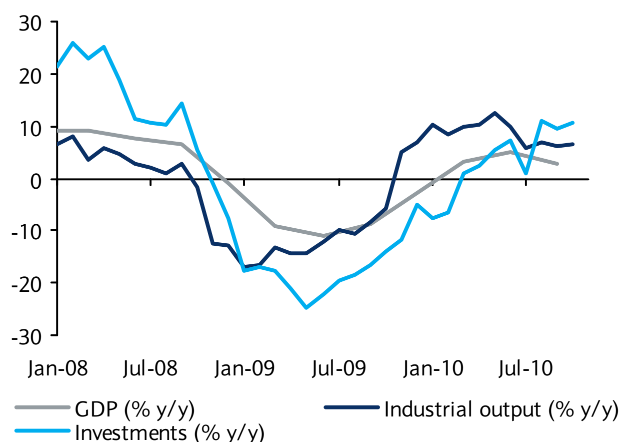
The summer heat wave continues to affect the pace of recovery and inflation. The economy hit a low point in Q3, with GDP growth slowing to 2.7% y/y vs 5.2% in Q2. Inflation has accelerated from 5.5% y/y in July to 8.5% expected at the year end. PMI readings point to continuing industrial recovery, yet its pace will likely slow. The consumer sector has been gaining momentum but also displayed weak results in October.

Figure 1: Loan growth accelerated and we expect it to continue gaining speed in the near term



Note: Dots denote CBR forecasts. Source: Bank of Russia

Figure 2: Investment has picked up recently but remains the most risky part of our outlook



Source: Haver Analytics

Russia has been at odds with trends in its EM peers

Overall, Russia remains a contrarian story. The rouble depreciated following the QE2 launch, and PMI declined in November against improvements in all other EMEA countries. The CBR expects capital outflows at USD22bn, while all major EM economies face large inflows.

Growth moderation sets in

We have downgraded our growth forecasts to 3.8% in 2010-11…

The latter part of the previous cycle was characterized by superior growth of consumer industries. However, several of the pre-crisis leading sectors (including common underperformers, such as construction, real estate and financial services) are struggling and are unlikely to contribute much to the recovery in the short term. Consequently, we expect growth to remain below 4% y/y. Nevertheless, we believe consumer sectors will gradually emerge as the main drivers of the economy in the near term. Growing wages and low unemployment will serve as a basis, supplemented by increasing consumer financing (Figure 1). If oil prices decline unexpectedly and/or domestic players display concerns about growth prospects, consumer confidence will deteriorate and depress growth. Our 2011 forecast of USD85 per barrel of Urals is close to current levels. However, if the average price remains at the level recorded this year (USD78), we expect Russia's growth to be 0.4pp lower. Our in-house oil price forecast for 2012 is USD105 per bbl. Applying the scenario of flat prices relative to 2010 would downgrade 2012 growth by 1.4 pp (to 2.6%).

… flat oil prices will reduce growth to 3.4% in 2011 and 2.6% in 2012, by our calculations

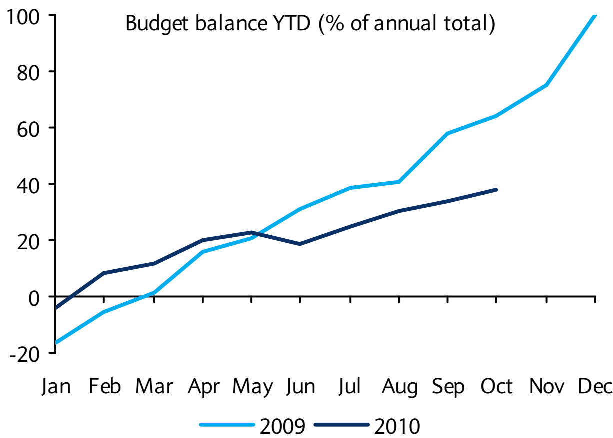
Investment slowing presents the biggest domestic risk to our growth scenario

Another major risk to our scenario is investment. Progress in recent months provides grounds for cautious optimism, with investment growth finally catching up with the rest of the economy (Figure 2). However, it is still too early to 'rest easy' as there are plenty of examples of when changing sentiment resulted in significant economic consequences.

We expect stronger FDI activity next year

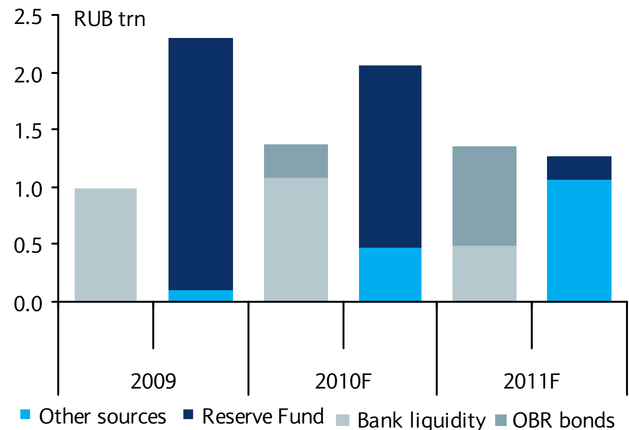
We also expect more foreign investor activity in Russia, mainly via FDI, stimulated by the privatisation programme. President Medvedev's modernisation drive is also beginning to bear fruit. More contracts are expected in the Skolkovo project; larger deals are being negotiated (eg, Renault-Nissan's interest in AvtoVAZ). The main risk to this scenario is political. The uncertainty about the 2012 presidential candidate is stemming interest from foreign investors. Even in the best case, we believe the total FDI inflow will unlikely approach the peak of 2008 (USD75bn, or 4.5% of current GDP versus 21% for investments overall).

Figure 3: The budget has outperformed in Jan-Oct but end-year expenditures may sharply reduce the savings



Source: Finance Ministry, Barclays Capital

Figure 4: Most of 2011 deficit financing will come from the market; there is enough liquidity & BoR bonds to cover this



Source: Finance Ministry, Barclays Capital

Fiscal deficit improves but financing will be challenging

OFZ borrowing needs will likely increase by 40% next year

The budget has consistently outperformed official targets and even our expectations (Figure 3), but we are not revising our full-year 2010 forecasts, given the historical end-of-year spending increases. Deficit and public debt levels are likely to remain low, falling from 4.6% to 2.5% of GDP in 2011. However, the big challenge for next year is on the financing side, with the gross requirement at RUB1.62trn/USD52bn (RUB0.2trn from the Reserves Fund, RUB0.3trn from privatisations and RUB1.1trn of gross domestic financing needs). The RUB1.1trn of gross domestic financing is a 40% y/y rise, which we think will eventually push up local yields. In terms of timing we do not expect this to occur until mid-Q2 11: budget deficits tend to be low early in the year, thus money from the Reserve Fund, the potential sale of a rouble-linked Eurobond and the reinvestment of some of the maturing OFZs should cover the first 4-5 months' financing needs. However, after that point, the OFZ supply will likely need to be ratcheted up. We do not expect strong non-resident demand, given the uncertainties over the rouble. Potential sources of local liquidity that could be tapped include: 1) the RUB0.5trn of discretionary bank deposits at the CBR; 2) RUB0.87trn from maturing OBR bonds if the CBR opts not to roll these instruments; and 3) some maturing OFZs (Figure 4). On paper, this should be enough to cover the sales of OFZs. However, most of this is ultimately short-term liquidity, which would likely need the inducement of higher yields before being pulled into the OFZ bonds. Oil prices represent an added risk to the budget performance. Our baseline scenario is for a 9% rise in oil prices next year, but if they are flat y/y, the budget deficit would be 0.7pp of GDP higher next year and 2.4pp higher in 2012.

Flat oil prices can more than double budget deficit in 2012

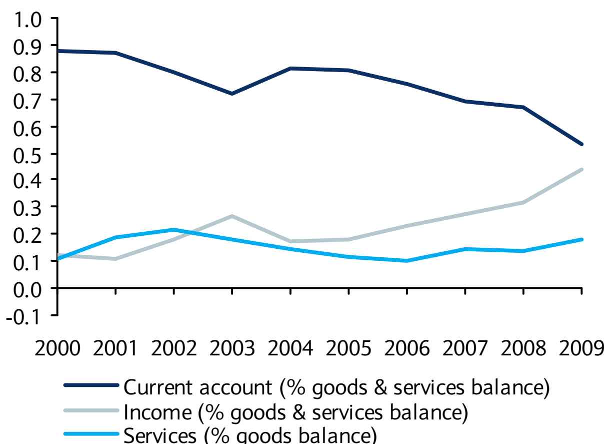
BoP uncertainty and loose monetary policy to continue

Declining current account balance raises sensitivity to capital account swings

Recent rouble woes have brought attention to the weakening of Russia's external position. Trade balances have declined on the back of accelerating import growth *vis-à-vis* flattish oil price dynamics. Coupled with increasing interest payments, this began to lower current account surpluses (Figure 5). We expect them to remain sizeable but under a flat oil price scenario they will likely shrink to USD36.7bn (2.6% of GDP) in 2011 and will approach zero in 2012 (USD3.8bn).

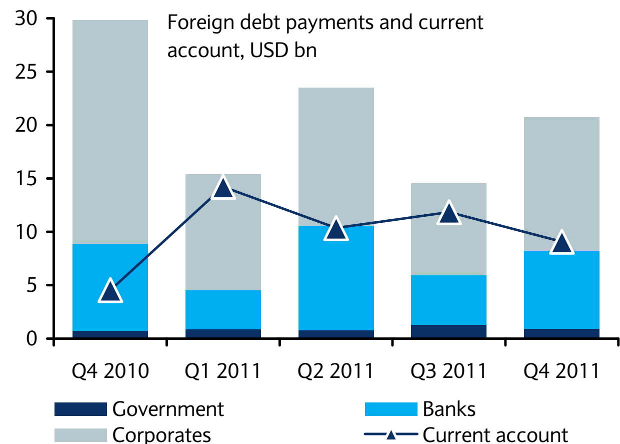
On the capital account side, external investments by Russian corporations (of which Lukoil and Gazprom share "buybacks" are the largest) and USD10bn VEB loan repayments have

Figure 5: (Negative) income balance is approaching the size of current account



Source: CBR, Barclays Capital

Figure 6: The seasonal pattern may again produce FX shortfalls in Q2-Q4 11



Source: CBR, Barclays Capital

contributed to the outflow, which the CBR estimates at USD22bn (1.4% of GDP). Combined with concerns about large foreign debt repayment in Q4, these contributed to significant reversals of long-RUB positions, as well as a weakening of the currency. Although we expect the capital flow picture to improve, we realize that a shrinking current account and more 'hands-off' CBR stance may make potential cross-border investment flows more disruptive.

Positive Q1 BoP outlook will support the rouble

Nevertheless, the beginning of the year seems likely to produce the usual strong current account flows against light debt repayments, thus forcing rouble to appreciate (Figure 6). We think the CBR will likely act more aggressively, but based on its recent refocusing on inflation, it may be forced to let some pressure through.

We think monetary policy will remain loose. Although rate hikes will likely start in Q1, negative real rates seem likely to continue indefinitely

The CBR has begun to switch to inflation targeting (ie, widening of the RUB target bands and intention to limit direct market participation) and this has further exacerbated the rouble's volatility. However, monetary policy remains loose, with real rates stuck in negative territory. We expect rate hikes to begin in Q1 but to stop well before the market-relevant rates (deposit and repo rates) reach the CPI level.

Figure 7: Russia macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	8.1	5.6	-7.9	3.8	3.8	4.0
Domestic demand contribution (pp)	9.7	7.0	-9.3	2.9	3.3	3.4
Private consumption (% y/y)	14.3	10.8	-7.7	2.6	5.5	4.8
Fixed capital investment (% y/y)	21.0	10.4	-15.7	4.7	5.8	5.2
Net exports contribution (pp)	-1.6	-1.4	1.4	0.9	0.5	0.6
Exports (% y/y)	6.3	0.6	-4.7	8.4	5.5	5.0
Imports (% y/y)	26.2	14.8	-30.4	17.1	12.0	7.5
GDP (USD bn)	1300.7	1670.5	1233.1	1505.8	1602.7	1773.2
External Sector						
Current account (USD bn)	76.2	101.3	47.5	65.5	45.4	36.8
CA (% GDP)	5.9	6.1	3.9	4.4	2.8	2.1
Trade balance (USD bn)	111.1	154.6	92.1	101.0	79.8	150.3
Net FDI (USD bn)	9.2	19.4	-7.3	5.0	5.0	5.0
Net other capital inflows (USD bn)	75.3	-150.7	-37.0	-9.3	-8.5	5.0
Gross external debt (USD bn)	463.9	479.4	471.6	490.0	535.0	560.0
International reserves (USD bn)	478.8	426.3	439.5	495.0	530.0	550.0
Public Sector						
Public sector balance (% GDP)	5.4	3.8	-5.9	-4.6	-2.5	-1.8
Primary balance (% GDP)	5.8	4.5	-5.4	-4.1	-1.9	-1.1
Gross public debt (% GDP)	7.5	5.3	8.5	8.2	9.3	9.2
Prices						
CPI (% Dec/Dec)	11.9	13.3	8.8	8.5	7.2	6.7
USD/RUB, eop	24.5	32.1	28.8	31.3	31.7	32.4
Urals oil price, avg	69.5	95.1	61.3	77.9	85.0	105.0
	1yr Ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	-8.6	2.7	4.2	4.3	3.8	3.8
CPI (% y/y, eop)	10.7	7.0	8.5	8.5	8.4	7.4
USD/RUB (eop)	30.1	30.4	31.3	30.8	30.8	31.1
Refinancing rate (%, eop)	10.0	7.75	7.75	8.25	8.50	8.50
1-week CBR deposit rate (%, eop)	5.3	2.75	2.75	3.25	3.25	3.25

Source: Rosstat, Bank of Russia, Finance Ministry, IMF, Haver Analytics, Bloomberg, Barclays Capital

EMEA: SERBIA

Not yet Dinar-time

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Serbia is struggling to gain traction on monetary policy, with inflation climbing rapidly and the exchange rate still vulnerable. With inflation rising, the NBS has been increasing its policy rate. However, it has been ineffective at stabilising the currency and stemming the rise in inflation. Declining balance of payments financing has kept the currency under pressure. In addition, the NBS has been lowering reserve requirements, causing M3 money to rise at a brisk pace. The fiscal policy and the IMF programme appear to be on track.

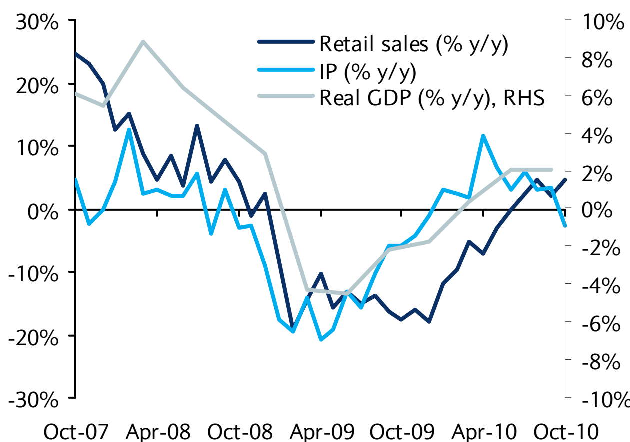
Strategy: We are closing our long RSD recommendation, given the continued challenging balance of payments metrics facing Serbia. The dinar has become a higher carry currency, reflecting the aggressive monetary tightening by the National Bank of Serbia. However, the risk on the dinar has also risen. The sources of financing the current account deficit remain sparse, with FX reserves still under pressure (albeit replenished periodically by donor flows). As it stands, the interest rate hikes have not yet led to an adjustment in Serbia's savings metrics to stabilise the current account or induce meaningful carry trade inflows to finance this deficit. We can envisage a scenario in which the current account financing stabilises in 2011. A neutral stance on the dinar thus seems warranted right now.

Growth recovering

Serbia has had positive growth in 2010

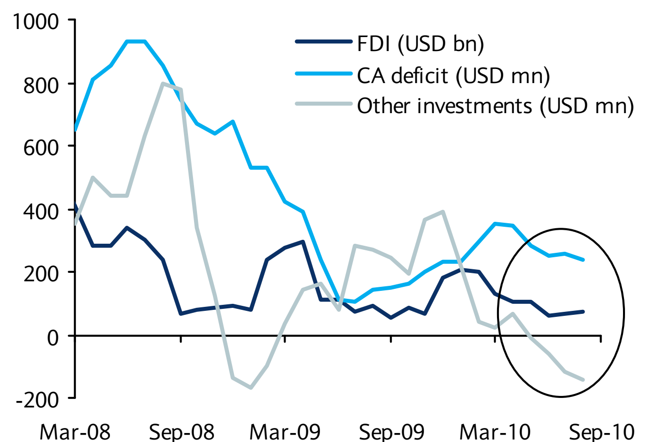
Serbia's economy appears to be on a gradual recovery path. GDP growth accelerated to 2.1% y/y in Q3. We forecast growth of 1.7% in 2010 and an increase to 2.5% in 2011. The factors supporting growth are net exports and consumption. Exports have remained strong (more to CEE countries than to the euro area), rising off a low base and being up by 17% year to date in the first three quarters of 2010. Retail sales have been increasing since July, while industrial production surprisingly decelerated in October following a period of steady expansion (Figure 1).

Figure 1: Recovery is gradual and unstable



Source: Statistical Office of the National Bank of Serbia, Haver Analytics

Figure 2: CA deficit financing has decreased in 2010



Source: National Bank of Serbia, Haver Analytics

Current account vulnerabilities

CA deficit likely to widen in 2010, while FDI are much lower

The current account deficit has been expanding since mid-2009 because of lower remittances and income receipts (Figure 2). Even though exports (+17% year to date) are growing more rapidly than imports (up 5% year-to-date), the trade balance has remained broadly unchanged as imports are much larger in nominal terms. Thus, we estimate the current account deficit will widen to -9% of GDP in 2010 from -6.7% in 2009. At the same time, financing is declining. FDI in 2010 is at about half the 2009 level, when it benefited from a large energy privatization, and is covering only about 30% of CA deficit year-to-date. In 2011, we expect a boost in FDI from the privatization of the state telecommunication company, which is expected to bring in about USD1.9bn probably in the second half of the year. With virtually no other inflows (capital, portfolio or loans), the NBS has had to finance the current account deficit through reserve depletion, which fell by USD1.5bn during the first three quarters of 2010 (Figure 3). There is not much relief in sight currently other than privatisation inflows and official financing. The exchange rate has been under considerable pressure since 2008, depreciating 40% versus the euro.

Surging inflation

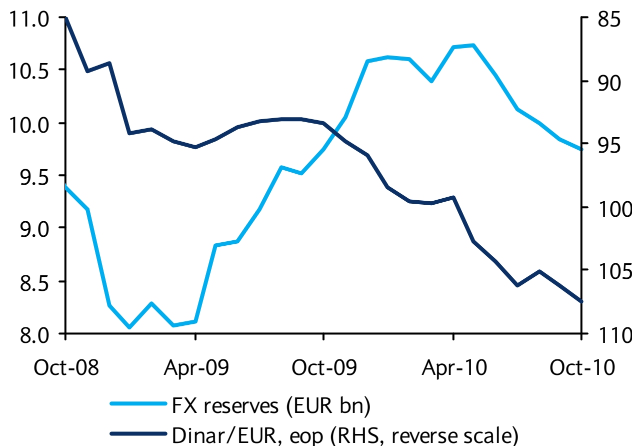
During 2010 inflation has more than doubled to 9% y/y (Figure 4). The main contributing factors have been currency depreciation and higher food prices, although price pressures are widespread with high inflation in almost all categories. The food price shock was magnified in Serbia by the structure of the local food market as well as the damage caused by heavy rains to the local harvest. Exchange rate depreciation pass-through appears to have been higher than in the past. Inflation is still accelerating, and we expect it to peak at 11% y/y.

Monetary policy tightening

NBS is raising rates while cutting bank reserve requirements; thus monetary policy has not stabilised the exchange rate nor stemmed the inflation surge

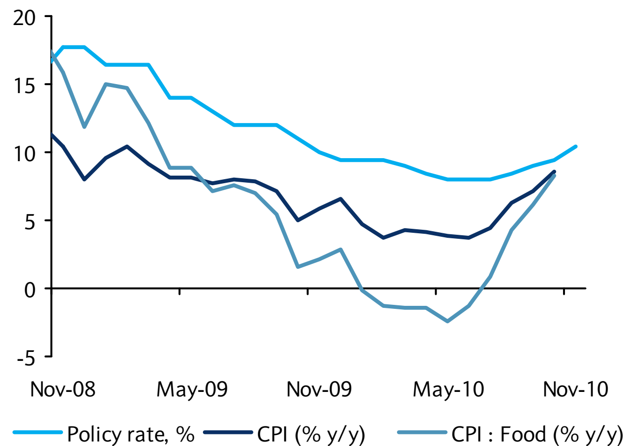
NBS has responded to the rising inflation by hiking its policy rate in four increments (starting in August) by 250bp in total to 10.5%. Given that we expect inflation to keep rising to 11%, further rate increases of 250bp are expected. There are upside risks to inflation and the policy rate. The basic problem, in our opinion, is that while hiking rates the NBS has been loosening monetary policy via reductions in bank reserve requirements. In March 2010, the

Figure 3: NBS has been using reserves to combat dinar depreciation



Source: National Bank of Serbia, Haver Analytics

Figure 4: Inflation has surged in recent months



Source: Statistical Office of the National Bank of Serbia, Haver Analytics

NBS initiated a programme to bring uniformity to reserve requirements by lowering the requirements on FX deposits from 40% to 25%, while phasing out credit support programmes. This has led to a gradual releasing of reserves to banks. Such a move is classic monetary policy loosening that increases the money multiplier (Figure 5). So while the NBS has been raising rates, it has been increasing money supply at the same time. Clearly this makes monetary policy less effective at stabilising the exchange rate and bringing down inflation – a risk we have previously highlighted. Recent data imply there may have been a halt in the increase of M3 money in the past three months. If the NBS maintains the stability of M3, this could help to stabilise the currency in 2011.

International support

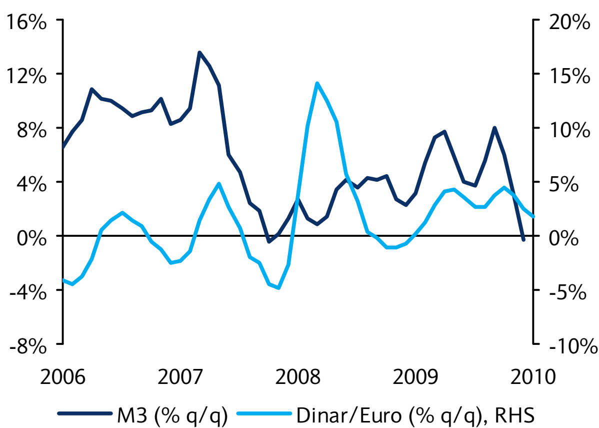
IMF programme is on track

The NBS increased its international reserves in 2009 with the help of the IMF-led support programme. In 2009, it received USD1.6bn in loans. In 2010, disbursements from the IMF have been lower (at USD0.3bn), because the NBS has refrained from using all of the loans available to avoid penalty interest rates.

Budget deficit to reach 4.8% of GDP in 2010, but overall fiscal dynamics are relatively strong

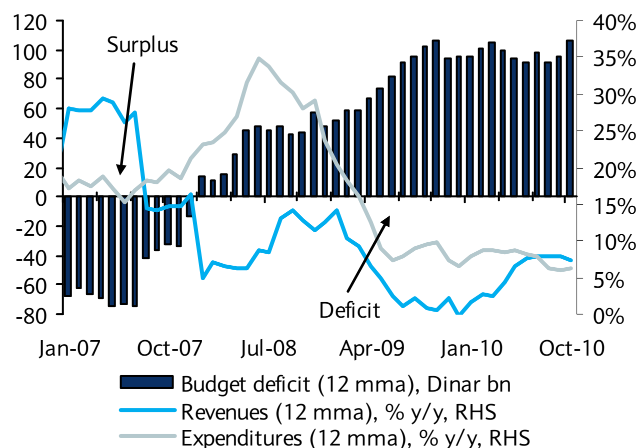
Serbia has remained on track with its IMF programme. The government recently passed a revised 2010 budget to ensure it reaches the 4.8% of GDP deficit target. It is also in the process of adopting the 2011 budget with a 4.1% of GDP deficit target, in line with the new fiscal responsibility rule. The budget will incorporate agreed-upon expenditure and revenue measures including freezing of subsidies and limited indexation of wages and pensions. The government is also submitting amendments to the law on pensions and disability insurance to strengthen protection for the most vulnerable. Indexation of wages and pension resumes in 2011. The government can increase the deficit in 2011, if it increases capital spending ("Golden rule"). However, there is a debt limit of 45% of GDP. Currently, debt is about 40% of GDP, leaving Serbia's fiscal dynamics strong. One of the main medium-term strategies for controlling the budget deficit is to decrease the government wage bill. Fitch recently raised the outlook to stable from negative on Serbia's BB- sovereign ratings on local and foreign currency debt.

Figure 5: Money supply increases could help explain currency movements



Source: National Bank of Serbia, Haver Analytics

Figure 6: Fiscal deficit has stabilized



Source: National Bank of Serbia, Public Payment Agency, Haver Analytics ,

Fiscal financing

Originally, the government expected to cover an increasing share of the deficit financing through issuing Dinar bonds. However, currency depreciation and increases in inflation damaged confidence, and auctions of Dinar securities have been undersubscribed. The government switched to issuing more short-dated t-bills rather than long-dated bonds and may obtain loans or issue bonds in FX in the domestic market.

Banks

NPLs continue to rise, but banks' capital appears adequate

Serbia's banking system has been damaged by the financial crisis. NPL have risen to 17.5% of loans in June. However, provisions cover about half of this. Banks' capital-to-asset ratio at 20% appears adequate. Bank loans have been increasing, notwithstanding the financial troubles of the banks. About 10% of bank assets are owned by Greek banks. The Vienna Accord negotiated by EBRD and IMF was an agreement by foreign-owned banks to keep their capital in Serbia at 100% of pre-recession levels. The agreement was renegotiated in 2010, and the level of assets was reduced to 80% to allow more flexibility. At this point, banks appear to be voluntarily maintaining capital.

Politics

EU accession still seems distant

Structural reforms slowed down due to lack of coordination in the coalition government

In recent months, Serbia has made some progress towards its eventual integration into the EU, though membership itself seems distant. The EU recently provided a 2,500-page questionnaire on political, economic and social reforms the country must undertake to join. Serbia hopes to achieve candidate status by the end-2011, although its insufficient cooperation on prosecution of war crimes, according to the EU, remains one of the main obstacles. On the political front, with a ten-party coalition government in place, there is a clear lack of agreement and coordination between the coalition partners. This has contributed to a slow pace of structural fiscal reforms. Serbia will have next parliamentary elections at the latest in May 2012.

Figure 7: Serbia macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	6.9	5.5	-3.1	1.7	2.5	3.0
GDP (USD bn)	39.4	48.8	43.0	45.2	49.0	53.2
Current account (USD bn)	-6.3	-8.6	-2.9	-4.0	-5.3	--5.0
CA (% GDP)	-16.0	-17.7	-6.7	-9.0	-10.8	-9.4
Gross external debt (USD bn)	24.3	31.8	31.9	35.6	37.3	39.2
International reserves (USD bn)	14.2	11.5	15.2	13.5	13.5	13.0
Public sector balance (% GDP)	-1.9	-2.6	-4.1	-4.8	-4.1	-2.7
Primary balance (% GDP)	-1.2	-2.0	-1.1	-1.4	-2.7	-1.4
Gross public debt (% GDP)	35.2	33.4	35.6	40.5	41.6	40.4
Prices						
CPI (% Dec/Dec)	11.0	8.6	6.6	10.5	9.0	8.0
EUR/Dinar, eop	80.0	81.4	93.9	107.5	114	120
NBS policy rate (%, eop)	10.0	17.75	9.50	11.0	10.5	9.5

Source: Barclays Capital

EMEA: SOUTH AFRICA

Strong ZAR supports consumption

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The impact of numerous labour strikes have caused us to pare our 2010 GDP forecast to 2.8% (from 3.0%), lifting it to 3.6% in 2011. In our view, inflation has bottomed (3.2% y/y in September). However, favourable food prices and currency are likely to temper the pace of rising inflation in 2011 and these, together with the Reserve Bank's recent improved inflation view, should allow the MPC to leave policy rates on hold in 2011. Notwithstanding recent ZAR jitters, we see room for further strength into early 2011, before reversing slowly as developed economies recover and the local current account deficit widens.

Strategy:
Long ZAR Jan'20 (R207) bonds, FX unhedged

Strategy: Global risk jitters have largely resulted in some R10bn in fixed-income outflows from local fixed-income markets, triggering a 55-65bp sell-off in benchmark yields during November. We believe this has opened up good value, particularly in the R207 (2020), as technical factors (coupon payments will see the market cash rich into early 2011 and this impact will likely be exacerbated as debt auctions cease over the end-year period) and fundamentals (we expect the February budget to cut bond supply) are supportive. With regard to curve shape, the 2v10 is now pricing at +188, near the peak reached at the end of the last two cutting cycles and therefore, also attractive as a receive. At the front end of the curve, we are surprised that the market has not priced in further rate reductions, given the rate cut in November.

An expectation of gradually rising inflation and rand jitters are likely to blame, along with clearer signals that the consumer part of the recovery is gaining momentum. Consequently, we prefer FRA flatteners to position for the view that the first MPC hike will only occur in 2012. Any large rand moves in either direction will likely have an important impact on the FRA market. However, our baseline is for a generally supportive start to the year for the currency, particularly as October's budget signalled any unease with current strength was unlikely to be met with Brazil/Korea-style actions which may deter FDI but instead through changes to the regulations restraining outward flows from locals. For offshore markets, we believe that improvements in South Africa's fiscal profile could mean both S&P and Fitch re-appraising their negative outlooks of the credit. One or more of South Africa's large state-owned parastatals may enter the offshore market in early 2011.

Downgrading 2010 GDP forecasts, though the trajectory continues upwards

We have downgraded our 2010 GDP forecast to 2.8%

GDP slowed to 2.6% q/q in Q3 10 from a downwardly revised 2.8% q/q in Q2 10. While the slowdown was mostly due to a 22% q/q drop in the mining sector (owing to one-off maintenance and industrial action), slower Q3 10 growth occurred on account of both a one-off 5.0% decline in the manufacturing sector (due to strike action) and a broad-based deceleration in impetus across sectors. Our calculations show that without the sharp mining sector moves in Q2/Q3, and controlling the subsequent strike-induced decline in the manufacturing sector in Q3, underlying GDP growth moderated to 2.2% in Q3 10 from an underlying 4.4% in Q2. We expect some bounce in Q4 growth, although not enough to see a downgrade of our 2010 GDP forecast to 2.8% (from 3.0% previously).

Rising incomes and low debt-servicing costs drive consumption

For 2011 we expect a modest acceleration in economic growth as both household consumption and fixed investment progress further. Although expenditure-side GDP for Q3 10 will be published only on 9 December, high frequency data from the consumer sector leave us confident that household spending continues to contribute to the recovery, thanks largely to the combination of recovering real household incomes (as real wages rise rapidly

for the employed, helping to offset the impact of rising unemployment on total income) and lower debt servicing costs (record-low policy rates have generated much lower debt service costs, even though debt levels remain elevated). Add to this accelerating net household wealth since Q1 09 (thanks largely to stronger equity and bond markets despite an apparent slowing in house price growth) and higher consumer confidence in 2010 (14.5pts versus a bleak 3pts in 2009), and the medium-term path for household consumption growth looks promising.

Fixed investment should improve into 2011 as business confidence recovers

After an estimated 0.3% decline in gross domestic fixed investment (GDFI) in 2010 (thanks to many capital expenditure plans being cancelled or placed on hold), we anticipate a relatively sound recovery to 4.2% in 2011. This view is founded on our expectation that overall economic growth will remain relatively robust, while leading indicators such as building plans passed and business confidence will continue to recover. Nevertheless, the upturn in GDFI is expected to be gentle, given that the private sector may remain somewhat guarded over capital expenditure plans in the face of spare capacity.

We forecast GDP to average 2.8% in 2010, 3.6% in 2011 and 3.9% in 2012

On the whole, we still expect stronger domestic demand over the medium term, supporting our view that GDP will grow by 2.8% in 2010, 3.6% in 2011 and 3.9% in 2012.

Inflation is bottoming but the upturn will likely be slight

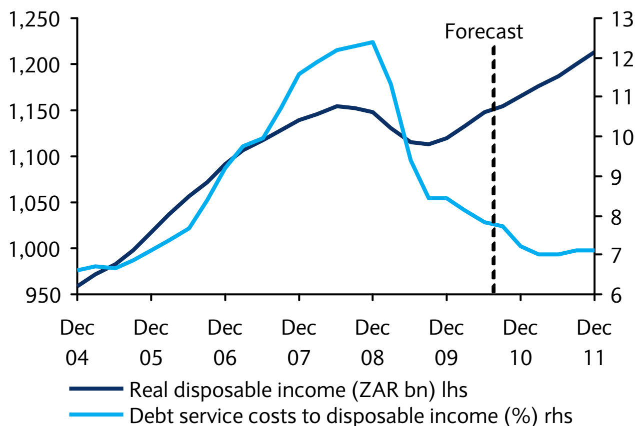
We expect the rise in CPI in 2011 to be slight, averaging 4.3%

In our view, inflation had bottomed in September 2010 at 3.2% y/y. However, thereafter, CPI has risen somewhat (3.4% y/y in October), the first upside surprise to monthly consensus forecasts in 16 months. Looking to Q4 as a whole, the major upside risk should stem from a total 37 cents/litre petrol price increase during the quarter, plus a small positive contribution from food prices. Nevertheless, we expect the downside pressures still emanating from the lagged impact of currency strength to leave Q4 10 CPI, averaging 3.4% y/y from 3.5% y/y in Q3, generating a full-year forecast of 4.3%.

Downward pressures from currency strength should continue to offset upside risks from commodity prices, unit labour costs and base effects

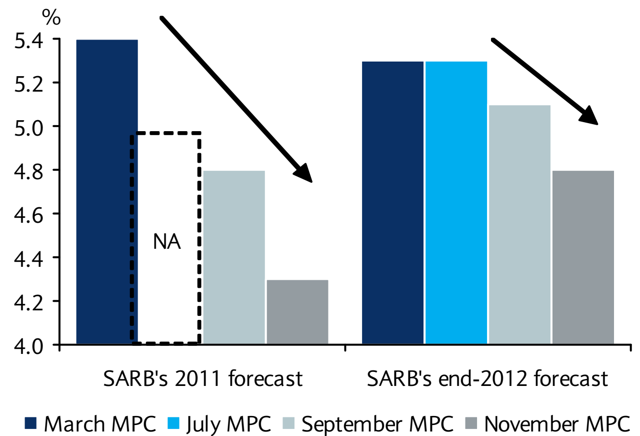
We see two key CPI themes to monitor in 2011. Currently, domestic soft commodity prices are particularly interesting as local dynamics are hardly worrying compared with the rest of the world. While US corn prices are running higher at 44.1% y/y in November, the local price of corn has fallen 3.2% y/y. This is largely due to the biggest corn harvest since 1982 together with poor distribution that inhibits farmers' ability to take advantage of higher export prices. The second CPI theme will be the rand, with our research highlighting that the

Figure 1: Income growth and low rates support consumption



Source: SARB, Absa Capital

Figure 2: The SARB's inflation estimates have fallen quickly



Source: SARB, Absa Capital *N/A: no forecast provided at the time

lagged impact of the currency on inflation can be large, and exhibit long lasting lags. These two factors will likely help to mitigate the impact of fairly strong H1 11 base effects CPI and to constrain the upside risks stemming from the global turn in commodity prices, large increases in local unit labour costs, and continued pressure on administered prices. Thus, even though we anticipate an upturn in the CPI trajectory from here on (to an average of 4.5% in 2011), we expect the rate of increase to be only slight.

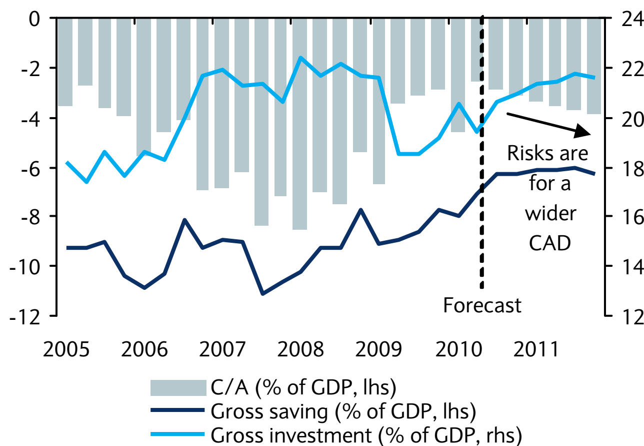
Given limited downside risk to the SA Reserve Bank's inflation profile, we forecast rates to remain on hold in 2011

This turn in inflation, combined with-late November jitters in the rand, have seen the rates market pricing in virtually no chance of a further rate cut in this cycle. Considering the sharp cuts to the SARB's own medium-term inflation projections that were delivered at the time of the November MPC rate cut, we see limited opportunity for a further improvement in the expected inflation path and as such, we believe that rates have reached the trough for this cycle. Rather, we expect the next move to be up by 50bp, but only from early 2012 as the economic recovery progresses further and the inflation outlook in late 2012 and 2013 begins to menace the 6% upper target.

Near-term currency strength is likely but from Q2 11 onwards, a widening current account deficit will pressurise the ZAR

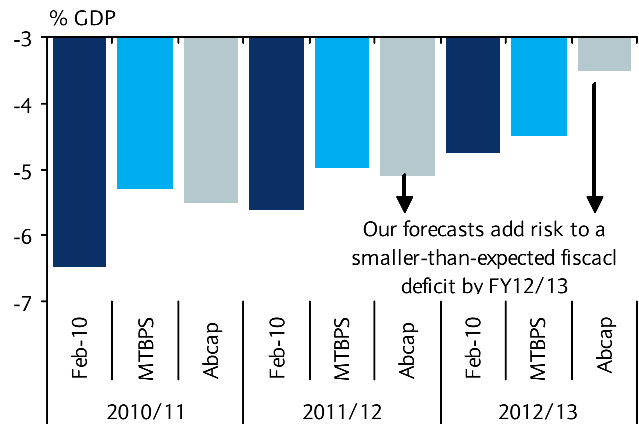
Big rand moves in either direction would likely perturb this calm policy rate scenario. While the ZAR continues to be driven by global appetite for emerging market risk, financial inflows (of bonds in particular) have slowed to some extent and the ZARUSD has traded slightly weaker (~ZAR7.14/USD). Nonetheless, we maintain that near-term strength is likely as the current European-focused risk aversion has to work its way out of the system; similarly the effects of quantitative easing continue to filter through the global system. We have pencilled in ZAR6.88/USD by Q2 11, and would expect to see stronger figures should the market become excited about the potential for a large FDI[4] in the retail sector between Walmart and South Africa's Massmart. Further out, we are less constructive on the rand - we anticipate that the developed world would command a higher growth premium, which should divert flows back to advanced economies. At the same time, however, South Africa's current account deficit should widen as consumer spending and capital projects demand a higher level of imports (from a low 2.5% of GDP in Q2 10, we expect the deficit to widen to 3.8% of GDP by Q411). As such, we forecast R7.24/USD by Q4 11 and a weakening to R7.95/USD by Q4 12.

Figure 3: C/A deficit at risk of widening into 2011



Source: SARB, Absa Capital

Figure 4: A tighter budget deficit is possible by FY12/13



Source: National Treasury, Absa Capital

[4] Walmart has made an offer to buy a 51% stake in Massmart – the offer is subject to regulatory approval.

We think the risk to the budget deficit over the medium-term is that it narrows quicker than Treasury's current expectations

Aligned to the government's New Growth Plan, one key component of our view is that accommodative monetary policy (rates on hold throughout 2011) is planned to be accompanied by more restrictive fiscal policy. To this end, stronger macroeconomic projections have already left National Treasury's main budget deficit projects a fair bit lower than previously (in October the FY10/11 deficit estimate was cut to 5.5% of GDP from 6.5% earlier). But even though Treasury appears determined to narrow the deficit over the medium term, we highlight that the risk is that the budget deficit narrows more quickly than is being anticipated; this is based on our view that National Treasury is underestimating the strength of nominal GDP growth over the medium-term.

Figure 5: South Africa macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	5.6	3.6	-1.7	2.8	3.6	3.9
Domestic demand contribution (pp)	5.7	3.8	-1.8	3.0	3.8	4.1
Private consumption (% y/y)	5.5	2.4	-3.1	2.6	3.9	4.7
Fixed capital investment (% y/y)	14.2	11.7	2.3	-0.3	4.2	5.3
Net exports contribution (pp)	-0.2	-0.1	0.1	-0.1	-0.2	-0.2
Exports (% y/y)	5.9	2.4	-19.5	3.3	7.0	8.1
Imports (% y/y)	9.0	1.4	-17.4	8.3	8.2	8.5
GDP (US bn)	286	279	289	363	418	435
External sector						
Current account (US bn)	-20.5	-19.8	-13.0	-12.6	-15.8	-17.0
CA (% GDP)	-7.2	-7.1	-4.0	-3.3	-3.6	-4.2
Trade balance (US bn)	-5.9	-3.6	0.3	1.7	2.5	1.7
Net FDI (US bn)	2.8	10.1	4.7	2.0	3.5	2.7
Other net inflows (US bn)	25.3	8.8	10.5	13.6	14.9	17.0
Gross external debt (US bn)	75.3	72.8	79.3	85.0	--	--
Gross international reserves (US bn)	31.3	33.5	39.0	44.8	47.8	49.1
Prices						
CPI (% Dec/Dec)	9.0	9.6	6.3	3.7	5.0	5.2
CPI (% average)	7.1	11.5	7.1	4.3	4.3	5.1
Exchange rate (USDZAR, eop)	6.83	9.96	7.49	6.95	7.30	8.01
Exchange rate (USDZAR, period average)	7.06	8.26	8.44	7.33	7.01	7.70
Public sector	**2007-08**	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**
Budget balance (% GDP) *	0.9	-1.2	-6.8	-5.5	-5.1	-3.5
Primary balance (% GDP) **	3.4	1.2	-4.5	-3.5	-2.4	...
Total govt debt (% GDP)	27.7	27.0	32.5	37.1	40.9	43.1
	1yr ago	**Last**	**Q4 10F**	**Q1 11 F**	**Q2 11F**	**Q3 11F**
Real GDP (% y/y)	-2.1	2.6	3.7	3.4	3.6	3.9
CPI (% y/y, eop)	5.9	3.4	3.7	3.7	4.2	4.7
Exchange rate (eop)	7.40	7.15	6.95	6.88	6.90	7.10
Monetary policy benchmark rate (%, eop)	7.00	5.50	5.50	5.50	5.50	5.50

Note: * Based on October 2010 MTBPS estimates. ** Based on February 2010 Main Budget estimates
Source: SARB, Stats SA, IHS Global Insight, Absa Capital

EMEA: TURKEY

Full throttle

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Turkey looks like the 'strong man of Europe', with a robust fundamental story of strong growth, financial sector health and robust debt dynamics. Our generally positive outlook notwithstanding, however, we also expect the current account to widen, TRY to appreciate in real effective terms, private credit growth to soar and monetary conditions to remain loose. While we remain constructive on Turkish assets, we look for ways to adjust our strategy to reflect some of the risks associated with these developments.

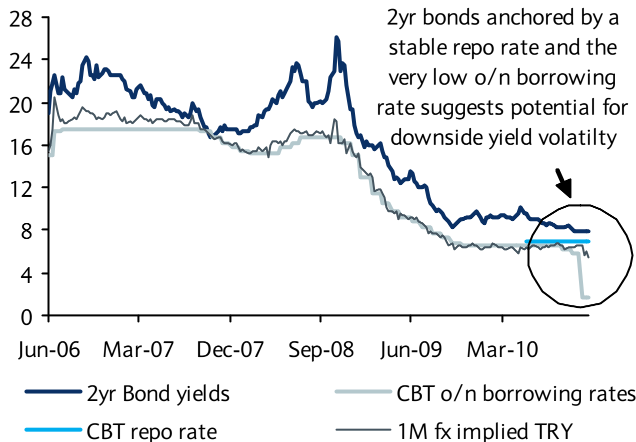
Strategy:
Rates – Stay long 2y bonds but add 2s5s steepener in CCS;
FX – Cautious but still long lira;
Overweight credit

Strategy: After the YTD appreciation in external and local markets, there is less room to manoeuvre on bullish trades. In rates, we still recommend being long Mar'12 bonds, which are about 60bp cheap to swaps. We expect swaps and bonds with short tenors to benefit from expectations that the CBT will keep policy rates unchanged for another 2-3 quarters. For levered investors, we recommend a 2s5s DV-01 neutral steepener trade in CCS, which reflects our view on short tenor rates but hedges against bouts of investor nervousness (for example, on concerns about l/t inflation). We still run a long lira trade (versus a basket of EUR and USD), but with less helpful BoP metrics the lira outlook has become less bullish. On Turkish credit, we maintain a slight Overweight recommendation in our Global EM credit portfolio. While tight valuations after the outperformance over the past few months may make Turkey credit vulnerable to some profit-taking in the short term, we expect a medium-term rating upgrade to investment grade status to provide a further boost and anchor for Turkey spreads. After the recent outlook upgrade by Fitch, an investment grade rating after the election in mid-2011 now seems likely, in our opinion.

Growth still strong, driven by credit-fuelled domestic demand

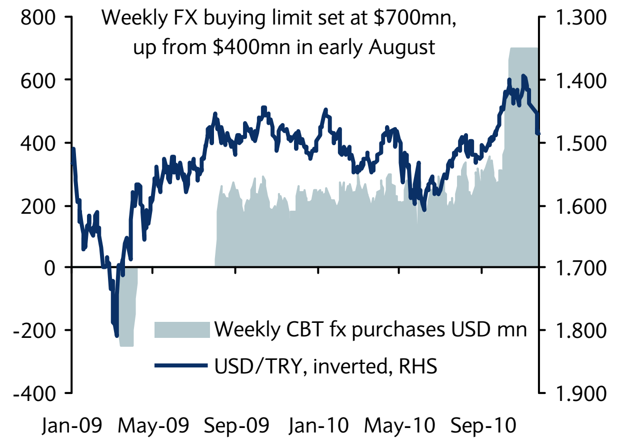
Turkey's growth performance remains strong. In stark contrast to most of the region, the output rebound is not only driven by the global recovery in trade and the reversal of crisis-related inventory developments but also by a strong contribution from credit-driven domestic demand. After the Lehman event, negative confidence effects triggered a deeper output contraction than one would have expected from a relatively closed economy with limited leverage. This confidence effect now seems to have reversed: as balance sheets proved their resilience during the global crisis, business and consumer confidence are up and credit growth is taking off against a backdrop of record-low interest rates. Private sector credit grew 27% y/y

Figure 1: 2y bond yields anchored by low policy rate



Source: Bloomberg, Barclays Capital

Figure 2: CBT's FX intervention is not without effect



Source: CBT, Barclays Capital

in real terms in October and an average of 17% in the first 10 months of the year. Together with an average 10% IP rise in Q3, October PMI at 54 and improving labour market data, this suggests that output growth remains stronger in H2 than we had expected. Given that GDP grew 11.0% in H1, we now believe GDP growth in 2010 could surpass 8%. Starting from a higher base in Q4 10 and with little reason to revise down our assumed q/q growth pattern for 2011, we also revise our annual 2011 growth forecast up to nearly 5%. We see growth moderating in 2012 but remaining above 4%. In light of the economy's external financing needs, the sustainability of this robust growth will depend on the continuing availability of foreign capital. While we think Turkey remains in a good position to receive such inflows, this will also depend on global developments, including monetary policy in core markets.

Current account deficit is widening rapidly, possibly up to 6% of GDP this year

External financing shifted markedly from FDI and long-term borrowing in pre-Lehman years to portfolio flows today…

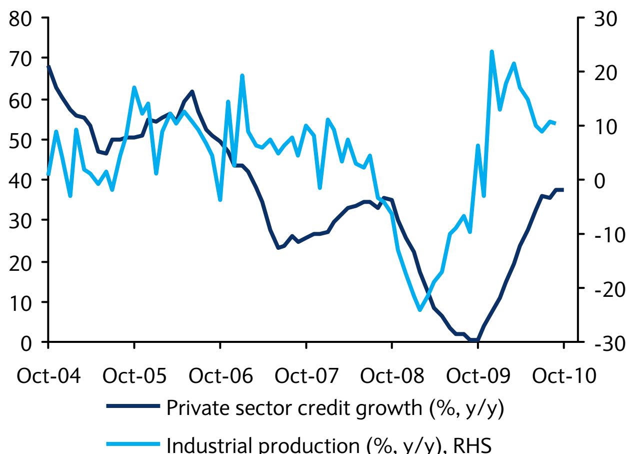
Thus far, the stronger-than-expected growth (and higher oil prices) has also led to faster-than-expected widening of the current account deficit (CAD): in September, it reached USD37bn on a 12-month rolling basis, and we expect it to reach about USD44bn by end-year, roughly 6% of GDP. With our house forecasts for the price of oil rising USD7/bbl on average in 2011 and the lira remaining strong, we see the CAD remaining roughly at this share of GDP in 2011 as well. Such CADs are reminiscent of those in the boom of 2006-07. Today, however, the composition of financing is more precarious. The FDI coverage of CAD is less than 14% (12 months rolling), while portfolio flows into local bonds and equity together with rising non-resident TRY deposits make up over 70%. The remainder is short-term trade credit and residents drawdown of foreign assets. The main capital inflow in the pre-Lehman years was medium and longer-term borrowing (ie, syndicated loans) by banks and non-bank corporates. Today, banking sector's net borrowing is pretty much flat and corporates remain large net re-payers of debt. In other words, while the corporate sector continues to de-lever, past borrowing from banks is being replaced by portfolio money.

… but this is part of an EM-wide phenomenon

Introduction of capital controls still not likely, in our view

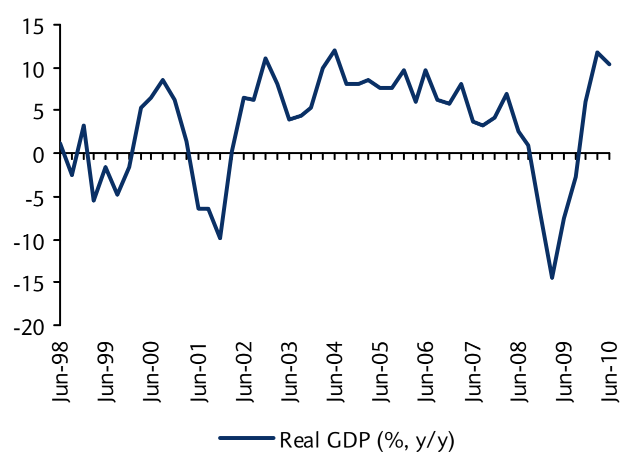
This is not specific to Turkey but reflects a general phenomenon of large portfolio flows into EM. In our view, substantial shares of the portfolio flows are likely to present strategic asset allocations into Turkey in recognition of its robust fundamentals. Turkey also remains one of the larger EM countries that has refrained from introducing capital controls. Instead, the CBT increased its daily FX purchase program significantly and lowered its overnight borrowing rate to just 1.75% to discourage pure carry trades. We also note that residents' retail FX deposits have risen steadily since mid-year, displaying their traditional contrarian behaviour of buying FX when TRY appreciates. We think the introduction of capital controls remains unlikely despite some critical remarks about "hot money" flows from PM Erdogan

Figure 3: Industrial production and credit have soared…



Source: Turkstat, CBT, Barclays Capital

Figure 4: … which generates a phenomenal growth rebound



Source: Turkstat, Barclays Capital

recently. Against this backdrop, we think there is limited room for additional nominal appreciation. At the same time, the CBT has no interest in a much weaker TRY, which would add to its challenge to deal with inflation. We also think inflows should remain sufficient to keep TRY relatively stable against the EUR/USD basket.

Headline CPI inflation surprised on upside driven by food

Core inflation continued to moderate to a very low rate

As output gap closes, we expect core inflation to rise

CPI inflation could end 2011 significantly above target

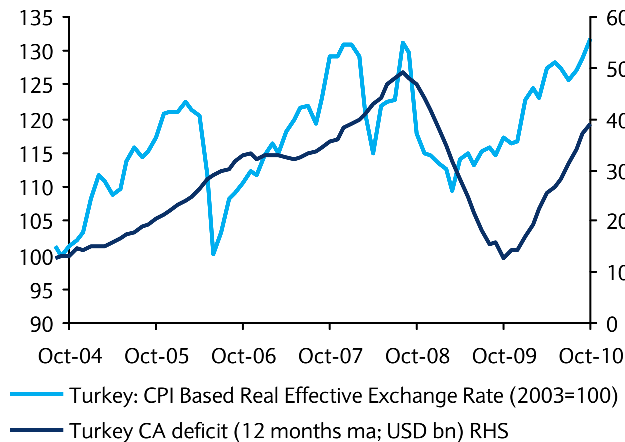
Inflation prints have been very volatile in recent months (eg, 7.3%y/y in November versus 8.6% in October), mainly due to food price swings. The CBT's favourite core inflation measure – the I-index (excluding all food, energy, alcohol & tobacco and gold) – has remained low (2.5% y/y). Beside food, the divergence between headline and core inflation is also explained by the continuing decline in housing rents (as the sector seems to still work through a supply overhang in certain segments) and price moderation in important categories such as clothing. This generally suggests limited demand pressures but may also reflect consumers' inelastic demand for food and energy, making them shift income from other goods and services. This may not continue, however, given the strong credit growth. High production rates and rising capacity utilization levels suggest to us that the CBT's view of a still fairly large output gap may be too optimistic. Favourable base effects from last year's tax and administrative price increases could drive headline inflation down, possibly to 5% in Q1 11. However, core inflation is likely to turn soon, in our opinion, and with the output gap closed, any exogenous food or energy price shocks would become more likely to create second-round effects. True, the high food price increases in recent months are likely to create a positive base effect in 12 months, helping to moderate headline in Q3, even if core inflation rises. Overall, we expect headline inflation to end 2011 at about 6.5% – above the 5.5% target, but within the 2pp uncertainty band.

CBT unlikely to hike rates before H2

We expect the policy rate to rise 150bp to 8.50% by end-2011

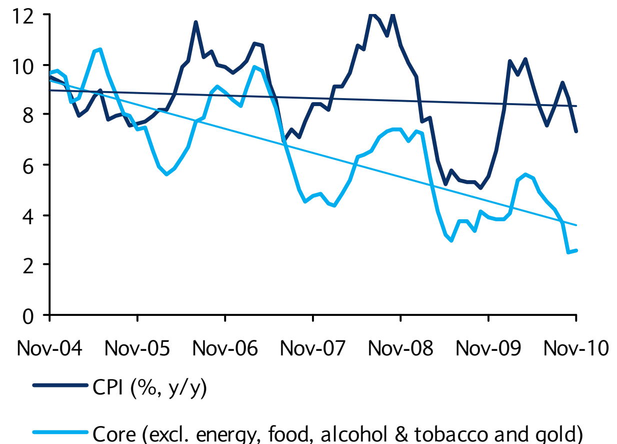
This inflation profile makes it very unlikely for the CBT to act on interest rates before the general elections in mid-2011. It would not only expose itself to criticism from politicians for raising rates but also to that of exporters for the potential FX appreciation. The issue becomes even more delicate as a new governor takes over the CBT leadership in April. We therefore forecast an initial hike in September and a rise to 8.50% by year-end (from 7.0% now). In the meantime, we imagine the CBT could use prudential measures beyond the 'exit strategy' to reign in credit growth (eg, raising reserve requirement ratios beyond pre-Lehman levels). Although successful policy implementation since the Lehman crisis has boosted the CBT's credibility, this remains a difficult balancing act. The risk remains that the CBT could get behind the curve, which could make adjusting the eventual tightening of monetary policy more abrupt than desired.

Figure 5: CA deficit is widening and the REER appreciates



Source: CBT, Barclays Capital

Figure 6: Gap between headline and core inflation to narrow



Source: Turkstat, Barclays Capital

Elections in mid-2011 likely to drive expenditures in H1

Public debt dynamics continue to look very healthy

Government debt could fall to below 40% of GDP by 2012

Polls show strong support for AKK in view of general elections

The need for monetary tightening also depends on the behaviour of fiscal policy. Thus far, fiscal performance has been encouraging due to much-higher-than-planned tax revenues. Ideally, the government would actively tighten fiscal to contain domestic demand in support of monetary policy, but this is not likely due to elections in mid-2011. From a fiscal sustainability perspective, however, Turkey is one of the region's countries that stand out positively. Although we expect primary spending to increase in the last two months, bringing this year's deficit to almost 4% of GDP – slightly higher than we forecasted – we still estimate the debt-to-GDP ratio to fall about 3pp to just above 42% of GDP. The government has been able to issue debt at nominal interest rates significantly below nominal GDP growth, which is likely to lower the government's interest bill in the years to come. If the government manages to move the deficit to 3% by 2012, we estimate the debt ratio falls well below 40% – a safety threshold often used for EM countries. Such a favourable scenario requires the political will for further deficit reduction; the rejection of the fiscal rule this year was a set back in terms of predicting fiscal policy. However, AKK's sound referendum victory in September and subsequent strong poll results for the general elections next summer have reduced the risk of any significant fiscal deterioration. Also, the potential upgrade to investment grade after the elections may provide additional incentive to maintain discipline. Overall, in a world in which public debt dynamics have become a major concern, Turkey's profile looks very sound, in our opinion.

Figure 7: Turkey forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	4.7	0.7	-4.7	8.1	4.7	4.3
Domestic demand contribution (pp) [1]	5.9	-1.2	-7.4	11.2	5.4	4.7
Private consumption (% y/y)	5.5	-0.3	3.1	4.5	4.3	4.2
Fixed capital investment (% y/y)	3.1	-6.2	-19.1	13.7	4.0	6.0
Net exports contribution (pp)	-1.2	1.9	2.7	-3.1	-0.7	-0.4
Exports (% y/y)	7.3	2.7	-5.2	5.1	6.0	7.5
Imports (% y/y)	10.7	-4.1	-13.1	14.0	8.0	8.0
GDP (USD bn)	653	741	619	735	815	901
External sector						
Current account (USD bn)	-38.3	-41.9	-14.0	-44.0	-48.0	-54.0
CA (% GDP)	-5.9	-5.7	-2.3	-6.0	-5.9	-6.0
Trade balance (USDbn)	-46.7	-52.8	-24.9	-54.0	-59.0	-64.0
Net FDI (USDbn)	19.9	15.7	6.3	9.0	10.0	12.0
Gross external debt (USDbn)	249	277	271	275	280	290.0
International reserves (USDbn)	73.3	71.0	70.7	81.0	88.0	93.0
Public sector						
Public sector balance (% GDP)	-1.0	-2.5	-5.9	-3.9	-3.3	-3.0
Primary balance (% GDP)	4.8	2.9	-0.2	0.6	0.7	0.4
Gross public debt (% GDP)	39.4	39.5	45.5	42.5	40.5	38.4
Prices						
CPI (% Dec/Dec)	8.4	10.1	6.5	7.1	6.5	6.4
USD/TRY, eop	1.17	1.54	1.50	1.50	1.47	1.45
	1yr Ago	**Last**	**Q4 10F**	**Q1 11F**	**Q2 11F**	**Q3 11F**
Real GDP (y/y)	3.1 (Q3)	10.0 (Q2)	3.2	3.8	4.9	4.7
CPI (% y/y, eop)	5.5 (Nov)	8.6	7.1	5.1	6.6	6.1
Exchange rate (USD/TRY, eop)	1.48 (Nov)	1.48	1.50	1.47	1.45	1.45
CBT policy rate (%, eop)	6.50 (Nov)	7.00	7.00	7.00	7.00	7.50
Market implied rate (%, eop)	NA	NA	7.00	7.25	7.50	7.75

Note: [1] Includes contribution from change in inventory. Source: Barclays Capital

EMEA: UKRAINE

More challenges ahead

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Ukraine has successfully passed the first round of the IMF Stand-By Arrangement. However, the recovery remains cyclically slow, leaving the country exposed to global steel price swings. The government still has to resolve several major challenges but we expect it to continue moving in the right direction. Shifting parliamentary elections to October 2012 provides more time to fulfil the reform agenda. Besides metal prices, we see the key risks for the economy in domestic investment and consumer demand recovery. Hryvnia dynamics will depend heavily on FDI flows.

Strategy:
FX/rates – Long UAH through VAT bonds or via the NDF; Credit - Overweight with a preference for shorter dated instruments

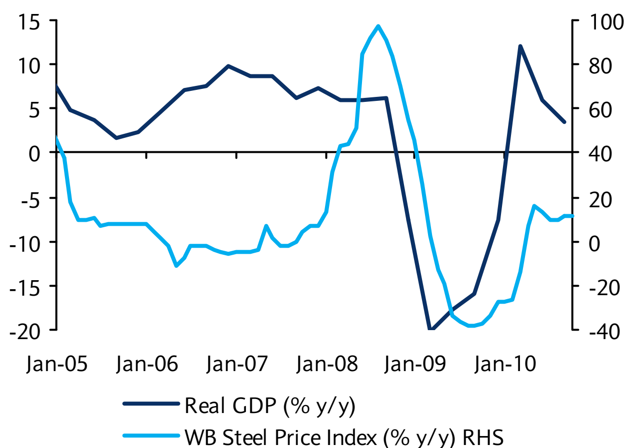
Strategy: Ukraine should be able to comfortably manage the external and fiscal funding challenges facing the country in 2011, particularly as we see only modest risks to the IMF programme. The Ukraine markets still appeal to us as locations for carry trades in both FX and credit. Spreads and yields have compressed significantly in the past twelve months and the sensitivity to global markets has risen, but Ukraine is still a location for alpha trades, in our view. In FX, we continue to advocate being long UAH, as the recent profit taking in the NDF market has returned more appealing yield levels for carry trades (eg, 1yr at 9% and +100bp m/m). We keep our long 5yr VAT bond recommendation (FX unhedged). The overall BoP metrics suggest UAH appreciation. However, we think policymakers will use inflows to rebuild FX reserves and keep the exchange rate stable (which would also balance the interests of exporters and households). In credit, we have no major concerns about upcoming bond maturities and note that the redemption schedule remains light through 2013. Hence, we are comfortable with long Ukraine credit positions with a preference for shorter-dated instruments, for which spread levels look particularly attractive. We recommend holding the Ukraine '12 and '13 bonds and/or selling shorter-dated CDS.

Economic recovery has slowed

Recovery has weakened in Q3

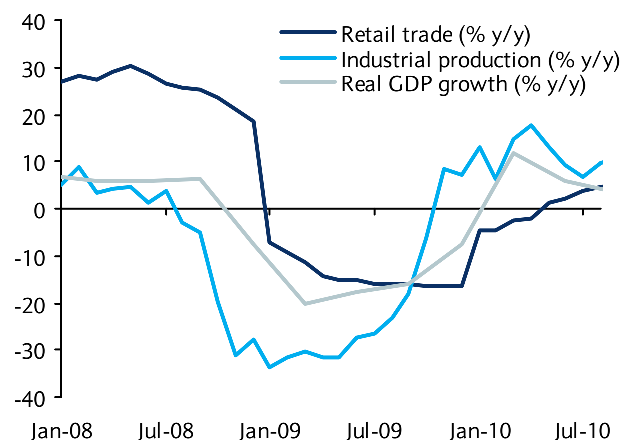
Ukraine's economic recovery hit a bump in Q3, with GDP growth sliding to 3.5% from a 5.4% y/y average in Q1-Q2. This looks even weaker when the low base effect is taken into account (GDP declined by 16.0% y/y in Q3 2009). In large part this was the result of the summer heat wave, and we believe some of the losses will be recovered in Q4. Latest IP

Figure 1: Steel price dynamics remains the main external risk



Source: Haver Analytics, Barclays Capital

Figure 2: Growth remains primarily driven by IP



Source: Ukrstat, Haver Analytics, Barclays Capital

readings (10.8% and 10.6% y/y in September/October respectively) confirm this. They also indicate that the economy continues to rely heavily on export-driven industrial expansion (Figure 2). Overall, the recovery appears to have lost some steam, prompting us to revise this year's growth forecast from 5.4% to 4.8%. We believe it will take Ukraine another three years to reach pre-crisis GDP levels.

Consumer sector keeps up its momentum but will continue to suffer from weak lending growth

The consumer side of the economy is picking up speed. Retail sales have been rising since May, expanding by 5.9% in October. However, the domestic demand contribution to growth remains small (we expect it to be 0.4 pp this year and 1.2 pp next). Ukrainian households remain burdened by debt accumulated by the end of the previous cycle, while banks have been focused on rebuilding their balance sheets in a process likely to extend at least into 2011. Recent trends in deposit and corporate lending growth are encouraging (Figure 3), as banks are being forced to expand lending to the economy by low capital market yields. However, it is too early to expect lending to become a major booster for consumer demand, leaving the latter dependent on an uncertain and volatile path of income growth (Figure 4).

Investments will likely give a strong boost to growth next year

Delayed banking system recovery has also held back investments, which we think will now likely improve. Preparation for the 2012 European Football Championship (EURO 2012) will intensify as well, with USD3.6bn (2.3% of GDP) earmarked in 2011 by the government for investment.

Meeting budget targets will be challenging in 2011

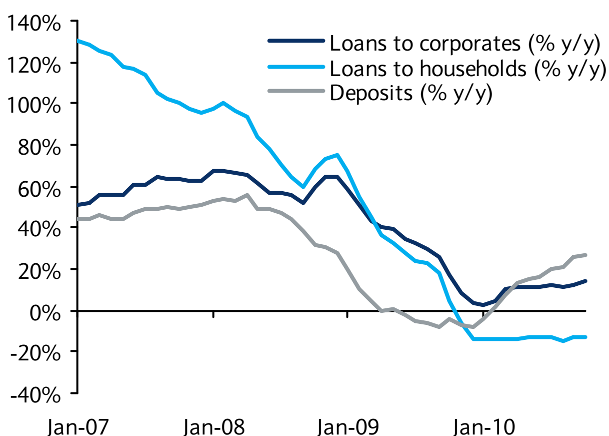
First Review by the IMF confirmed that this year's deficit target will be met

The First Review of the Stand-By Arrangement in November confirmed that the government is on track to meet the end-year targets. We believe the VAT refunds issue will be partially resolved, and will resurface in the next IMF review. Indeed, the government has increased refund payments this year but it is yet to fully deal with the legacy of arrears.

Meeting IMF programme targets will be tougher in 2011

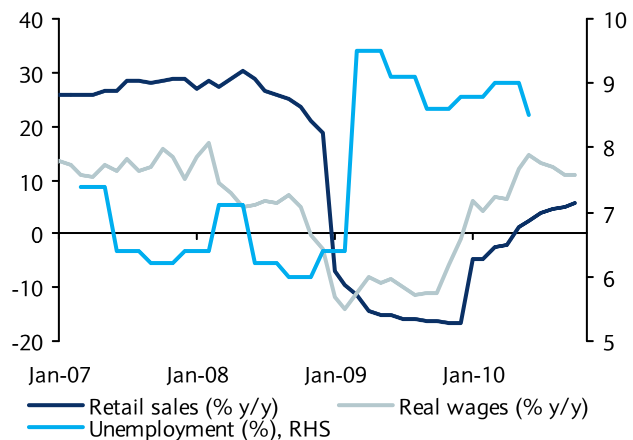
Overall, the fiscal programme will be tougher next year, as the budget deficit has to be cut from UAH59.6bn to UAH43.2bn (on relatively conservative assumptions this would also reduce domestic borrowing requirements from UAH46.5bn to UAH39.4bn). If the government succeeds in improving the terms of the gas import agreement with Russia, this would help balance Naftogaz books. Tax collection is another challenge, which may worsen with the introduction of the new tax code. The latter will raise the tax burden, particularly on SMEs, and will likely increase non-payments.

Figure 3: Deposit growth has accelerated, and bank lending has begun to catch up



Source: NBU, Barclays Capital

Figure 4: Growing wages and employment support consumer sector recovery



Source: Ministry of Finance, Barclays Capital

More BoP volatility may affect hryvnia but NBU stands ready to intervene

Current account improves but we think will deteriorate next year

Ukraine's external performance improved significantly over the past 24 months, with the current account temporary crossing into positive territory in Q2 (Figure 5). In the medium term, however, we think the best is behind us and the current account will deteriorate, albeit gradually as slow recovery lifts import growth. We expect this to be partially offset by capital inflows, but see this component as the main risk to our baseline BoP scenario. The Ukraine economy has a high propensity to import, reflecting low levels of productivity in the industrial sector. It is unclear if the tough times of the financial crisis have helped to turn this around.

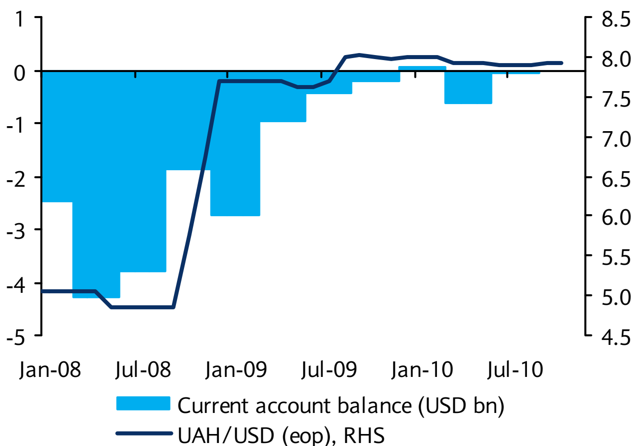
Capital flows will be the key determinant of BoP performance in the medium term

On the capital account side, the enduringly high foreign debt rollover ratios (at 96% in January-September) should reduce the risks associated with upcoming payments. Going forward, with a less onerous macro outlook, this ratio should hold. There is a question mark over whether improving corporate balance sheets, as seen in some CE economies, will lead to a release of pent-up dividend repatriation. Another key factor to watch are investment flows. We expect FDI volumes to expand in the medium term. EURO 2012 is the theme broadly covered in the media but there are other, less prominent areas which are important. Privatisation so far looks like an unfulfilled promise but we think this area offers some hope going forward. This is as a relatively easy avenue to boost budget financing, particularly during less-stressed market conditions. There have been increasing signs of strong interest in gas distribution and storage assets from Russian businesses. This could lead to sizeable transactions. Resumed negotiations on a JV between Gazprom and Naftogas are a step in this direction. If successful, the renegotiation of the gas price accord with Russia will likely serve as a "double bonus" for the BoP, lowering gas import payments and boosting gas transit receipts in exchange for investment into local assets. Otherwise, as widely reported, telecom and shipping assets are at the top of the government privatisation list.

UAH may weaken slightly in Q1 but NBU will limit the impact of higher current account deficit

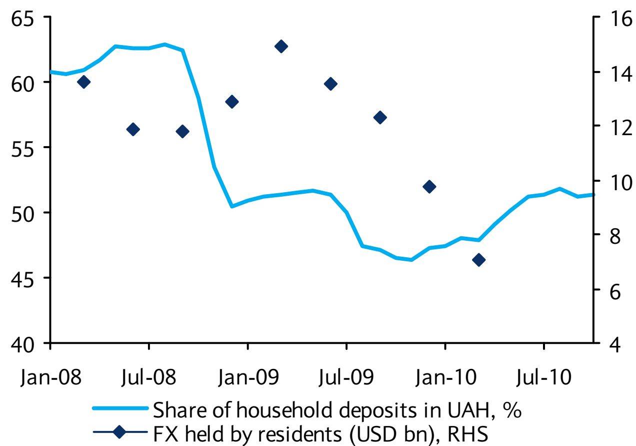
Hryvnia weakening in September created some nervousness on the domestic market. The population, which holds about half of its bank deposits in foreign currency, is clearly not at ease with the hyrvnia as a 'store of savings' (Figure 6). The NBU estimates net FX purchases by households at around USD3.6bn in September/October. On the risk front, the current account is seasonally weak in Q1, which may add to some short-term pressure on the UAH and extend the FX buying streak of the population. However, the BoP is in generally firm shape and the NBU is prepared in case there is another round of UAH sell-off, with excess NIR reserves at

Figure 5: Improved current account has been the main supporter of UAH appreciation



Source: NBU, Barclays Capital

Figure 6: Large share of FX deposits indicates local cautiousness towards the UAH



Source: NBU

USD4.5bn (on the basis of the December 2010 IMF targets). More importantly, the bank seems strongly committed to maintaining currency stability and has good reason to be: a stable UAH balances the interests of exporters and households; given lingering memories of the 2008/09 periods of market stress, a depreciation trend could lead to self-feeding FX buying in the market. We look for FX volatility to moderate back to the low levels of mid-2010, and this could kick off some further, modest, de-dollarization flows.

Political risks remain but should not impede the reforms

October elections and the row over the tax code demonstrated political danger of radical reforms

October local elections produced a warning to the ruling Party of Regions that strict economic policies can cost votes. But the main opposition parties did not manage to gain much from the elections either. More interesting was the presidential veto on the new tax code caused by of demonstrations organized by small and medium businesses. We view this as a prudent decision in light of the potential massive shift of small businesses into the shadow economy. However, the veto illustrates the current limits of state power in Ukraine, even though the end-result, apparently, did not bring substantial changes to the document. Therefore, it is too early to discount the risk of other reforms stumbling over popular discontent.

Figure 7: Ukraine macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	7.6	2.1	-15.1	4.8	4.5	4.5
Domestic demand contribution (pp)	16.8	8.2	-26.8	3.4	-0.1	5.4
Private consumption (% y/y)	17.2	10.2	-12.4	4.0	5.0	4.7
Fixed capital investment (% y/y)	24.4	1.9	-46.6	0.1	4.7	6.5
Net exports contribution (pp)	-9.2	-6.1	11.7	1.4	4.6	-0.9
Exports (% y/y)	2.8	5.5	-26.1	17.2	3.4	6.6
Imports (% y/y)	23.9	16.8	-41.2	13.7	6.5	4.0
GDP (USD bn)	142.7	180.4	115.6	135.2	155.3	174.1
External Sector						
Current account (USD bn)	-5.3	-12.8	-1.7	-1.8	-2.3	-3.0
CA (% GDP)	-3.7	-7.1	-1.5	-1.3	-1.5	-1.7
Trade balance (USD bn)	-9.0	-16.9	-3.1	-3.9	-8.8	-12.5
Net FDI (USD bn)	9.2	9.9	4.7	7.6	11.0	10.3
Net other capital inflows (USD bn)	5.5	3.4	-9.2	1.8	-0.8	1.4
Gross external debt (USD bn)	80.0	101.7	104.0	115.0	130.0	155.0
International reserves (USD bn)	32.5	31.5	26.5	34.3	37.8	41.3
Public Sector						
Public sector balance (% GDP)	-1.1	-1.5	-4.1	-6.5	-4.2	-3.3
Gross public debt (% GDP)	12.3	19.9	35.2	36.9	38.2	39.1
Prices						
CPI (% Dec/Dec)	16.6	22.3	12.3	11.0	9.2	7.9
UAH / USD, eop	5.1	7.7	8.0	8.0	8.1	8.3
	1yr Ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (% y/y)	-16.0	3.5	5.0	5.0	4.7	4.0
CPI (% y/y, eop)	15.0	10.5	11.0	10.3	12.3	9.5
Exchange rate (eop)	8.0	7.9	8.0	8.0	8.0	8.0
NBU policy rate (%, eop)	10.3	7.8	7.8	8.3	8.8	8.5

Source: Ukrstat, NBU, Finance Ministry, IMF, Haver Analytics, Barclays Capital

EMEA: ZAMBIA

Robust growth looks poised to continue

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Buoyant activity in the mining, agricultural and tourism sectors should ensure that Zambia's economic outlook remains on strong footing. Boosted by record FDI inflows and continued infrastructure expenditure, we expect growth of above 6% in each of 2010 and 2011. The general elections set for October 2011 suggest policy uncertainty and some risk to the currency, although previous polls indicate a peaceful outcome.

Strategy: Shorter-dated government bond yields have declined in recent months, easing to levels close to the historical lows reached in Q2 10. At the 19 November auction, the 2y, 3y, and 5y bonds were issued at yields of 7.99%, 8.99%, and 12.52%, respectively. Investor interest remains concentrated at the short end of the curve, and we see limited scope for significant further decline in yields amid a tightening in liquidity conditions. The currency outlook over the medium term remains upbeat, and we expect continued firm copper prices to underpin the kwacha in 2011. However, the currency may weaken closer to the elections in October 2011 as a result of policy uncertainty.

USD500mn Eurobond issuance planned for early 2011

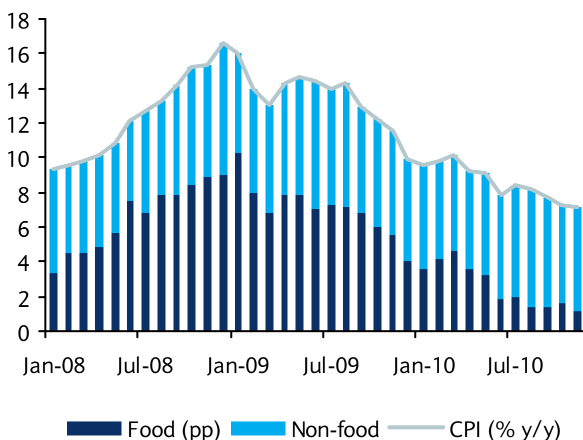
Zambia's government intends to forge ahead with plans to issue its maiden Eurobond of USD500mn in H1 11 once it has obtained a sovereign rating.

Fundamentals remain sound

Mining sector will remain a key driver of growth for Zambia

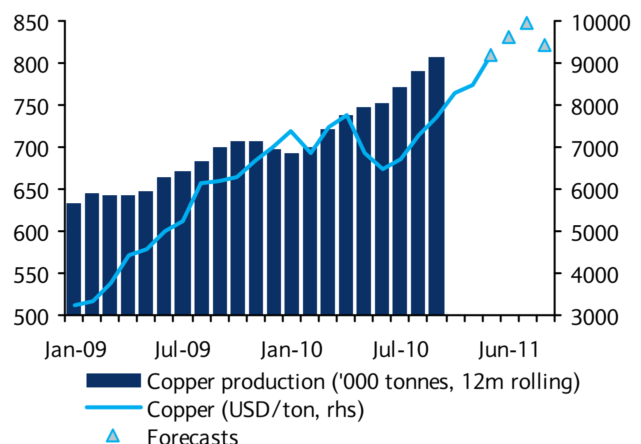
We believe the strong growth momentum in 2010 will continue into 2011. Buoyant activity in key sectors sets the tone for above-trend growth in the year ahead, in our view. FDI inflows, mainly into the mining and manufacturing sectors, have reached record levels totalling USD4.3bn (27% of GDP) in 2010, more than double the total FDI inflow of USD1.8bn in 2009. We expect mining activity to remain strong next year, underpinned by higher production and firm copper prices. Our commodities team forecasts copper prices to average 27% y/y higher in 2011, which bodes well for further investment into production capacity – investment into the mining sector has seen copper production surge 21% y/y to 625,844 tonnes in the first nine months of 2010. Overall, we expect a positive contribution from the external sector, coupled with improved private consumption and infrastructure spending, to result in growth of close to 7% in 2011 from an estimated 6.6% in 2010.

Figure 1: Low food inflation to keep a lid on overall inflation



Source: CSO, Absa Capital

Figure 2: Copper production and price outlook favourable



Source: BoZ, Absa Capital, Barclays Capital

Following record agricultural output in 2010, inflation has eased to a historical low of 7.1% y/y in November, with food inflation (57% of the consumer basket) easing to 2.5% y/y. Large domestic food stocks mean inflation should remain anchored within single digits in 2011, in our view. We expect inflation to print within the 8% target by end-2010, while we see risk that the 7% year-end target for 2011 may not be met owing to anticipated higher energy prices and stronger domestic demand. We expect inflation to increase steadily to about 10% by end of 2011.

Narrowing of current account deficit may support ZMK

Against the backdrop of expected firm copper prices and production and favourable demand conditions, we anticipate a further narrowing in the current account deficit in 2011. While exports should gain from higher volumes and prices, an increase in investment and domestic consumption may drive imports higher. Trade activity in January-October 2010 is reflective, with exports having risen 74% y/y, underpinned by higher copper exports (about 75% of total exports) and a 51% rise in the import bill. The trade balance returned a surplus of USD1.3bn in the period, compared with USD337mn in the corresponding period in 2009. On the back of the stronger trade surplus, we estimate a current account deficit of around 2% of GDP for 2010. For 2011, we expect the current account deficit to narrow further, while we remain positive on the overall external account outlook, given our expectation for a steady inflow of private capital.

Lower copper prices and elections may affect the exchange rate in 2011

This bodes well for the currency over the medium term, although we highlight two risk events. First, should global growth disappoint, especially that of large emerging markets, a pullback in copper prices may have an immediate effect on the currency and other macro indicators. Second, the election risk in October 2011 may also affect the currency. Zambia has had peaceful elections since becoming a multi-party democracy in 1991. However, the presidential elections between the MMD's President Banda and the opposition PF's Michael Sata will likely be closely contested, which may result in increased uncertainty around the elections.

Zambia's fiscal stance remains expansionary; government expected to launch maiden Eurobond in 2011

Looking at the fiscal balances, Zambia's government has been the most prudent in the region in managing its finances through the global crisis. The government anticipates a slight widening in the budget deficit to 3.4% of GDP in 2011 from an estimated 3.3% in 2010. The budget prioritises infrastructure and social spending and sees 15% y/y and 13% increases in expenditure and revenue in 2011, respectively. Given relatively low debt levels and sufficient domestic liquidity, we believe financing prospects are plausible, with planned domestic and external borrowing of 1.4% and 2% of GDP, respectively.

Figure 3: Selected macroeconomic forecasts

	2006	2007	2008	2009	2010F	2011F	2012F
Real GDP (% y/y)	6.2	6.2	5.7	6.4	6.6	6.8	6.7
Nominal GDP (USDbn)	10.7	11.5	14.7	12.7	15.6	18.7	21.5
CA balance (% GDP)	-0.4	-6.6	-7.1	-3.2	-2.3	-1.2	-2.9
FX reserves (eop)	0.7	1.1	1.1	1.3	1.5	1.7	1.8
External debt (% GDP)	8.8	8.4	11.2	11.9	13.4	14.5	15.0
Domestic debt (% GDP)	15.9	15.3	15.5	14.5	13.0	12.4	11.8
Overall fiscal balance (% GDP)	19.8	-1.3	-2.2	-2.7	-3.3	-3.4	-3.0
CPI (% y/y, eop)	8.2	8.9	16.6	9.9	7.5	9.7	12.4
Currency per USD (eop)	4407	3845	4832	4682	4900	4650	4850
1-year T-bill rate (eop)	9.11	11.41	13.58	5.05	5.80	7.00	9.00

Source: Bank of Zambia, IMF-IFS, CSO, Absa Capital

LATAM: ARGENTINA

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A favourable global backdrop should extend Argentina's economic momentum. Despite a deteriorating current account and accelerating inflation, domestic policies are expected to remain expansionary ahead of the 2011 presidential elections. Government financing is expected to become increasingly dependent on the central bank. Fundamental conditions could weaken in 2012. However, next year the country may have a relatively uneventful economic ride.

The global tail winds make it difficult for Argentina to have a low growth year

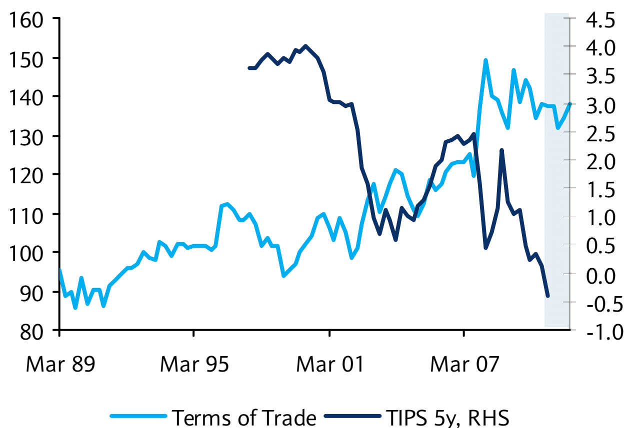
As complex as the global landscape is, it is pretty welcoming for Argentina. The country's terms of trade are near record highs. Argentina's comparative advantage typically resides in sectors that are capital- or time-intensive (natural resources, agriculture, wines, forestry); therefore, current low global real interest rates add to an extraordinary price vector for the country. Ample international liquidity and abundant central bank reserves have also significantly reduced investor anxiety that an Argentine crisis could be around the corner. Faced with such conditions, serious policy mistakes would be required in the next few quarters to result in a negative economic year for the country. Given the current political configuration in the country, we deem those mistakes unlikely.

We expect growth to be closer to potential, burdened by domestic distortions but aided by expansionary policies

Argentina is closing a year of spectacular recovery in economic activity (we estimate 2010 growth at 8.9%). While the recovery took place in the first half of the year, the second half has tended to maintain the activity level, and 2011 should evidence moderate growth (5.3%). It is apparent that the economy is operating at or near capacity and that above-trend growth has become difficult. An expected moderate harvest, the effect of electoral uncertainty on the business environment and investment, and a significant number of lingering distortions (energy shortages, inefficient public utility pricing, and discretionary regulations) conspire against a better year, in our opinion.

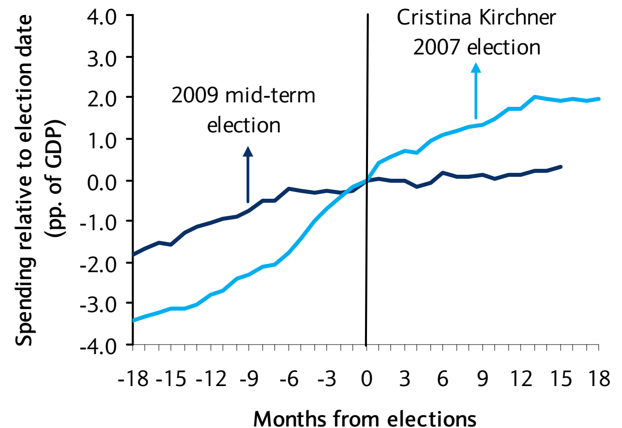
Growth in 2011 is likely to remain driven by domestic demand. Indeed, we expect domestic spending to outstrip GDP, resulting in two side effects: a deterioration of the current account and a (moderate) acceleration of inflation. We expect domestic demand to continue to be stoked by expansionary macro policies.

Figure 1: Terms of trade and global real rates



Source: Haver Analytics, Bloomberg, Barclays Capital

Figure 2: Government spending around elections



Source: Ministry of Economy Argentina, Barclays Capital

The electoral calendar is likely to create some uncertainty

Argentina celebrates presidential elections in 2011. After the passing of Nestor Kirchner, who was a likely presidential candidate, current president Cristina Fernandez de Kirchner was presented by members of her administration as a candidate for re-election. Her current standing in the polls places her as a favourite to win in a first round tally. However, these polls have shown significant volatility over the past two years.

We expect the fiscal stance to remain expansionary: spending growth above potential GDP

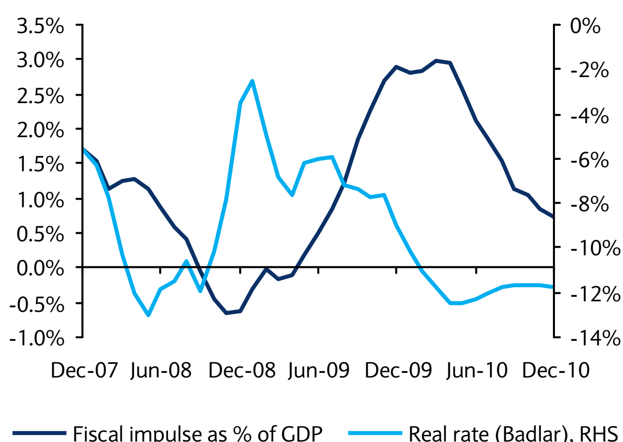
Because of volatile electoral preferences, the government is likely to continue to engage in expansionary fiscal policy. In 2007 and 2009, government spending as a share of GDP in the 12 months leading to the election expanded (3pp in 2007 and 1pp in 2009), then stabilized in the quarters that followed (Figure 2). We expect a similar pattern for 2011. While financing and the lack of a legislated budget should constrain aggressive spending growth in 2011, we still expect the government to grow spending faster than tax revenues and for the economy to continue to sport an expansionary fiscal stance. Indeed, adjusted for unconventional accounting and given the state of the business cycle, we expect the budget to add slightly less than 1% to aggregate demand (Figure 3).

Monetary policy to remain fiscally and FX dominated

The pattern of monetary policy is likely to remain unchanged. The central bank seems to be paying less attention to its monetary program or inflation and more to two key pillars of the government's policies: financing the Treasury and stabilizing the FX market. The proposed 2011 budget included significant support from the central bank to the government. The proposal aspired to use USD7.5bn of reserves to service international obligations. While the budget did not receive Congressional approval, the government maintained its power to pass emergency decrees. The president is likely to pass one such decree before the end of Q1 to appropriate such reserves. Furthermore, according to our calculations, the central bank is expected to provide ARS financing – through its normal operational procedures – for the equivalent of USD3.3bn. Finally, if Argentina reaches an agreement with the Paris Club, the payments could come from additional central bank support.

While support to the Treasury is expected to be very large, we do not expect a proportionate fall in international reserves. Indeed, high terms of trade should compensate much of the drain in reserves by preserving a solid trade balance (Figure 4). In fact, despite fast (real) import growth – a natural consequence of booming domestic demand and an appreciating real exchange rate – we expect the trade surplus to continue to supply the republic with

Figure 3: Fiscal and monetary policy remains expansionary



Source: Barclays Capital

Figure 4: International reserves could fall somewhat

USD bn	2010 E	2011F
USD sources	**20.8**	**12.8**
Net exports[1]	18.7	10.7
FDI & Portfolio	2.1	2.1
USD needs	**-15.6**	**-17.3**
Asset formation, net	-10.7	-8.0
Loans, net	1.1	1.1
Interests/Transfers	-7.5	-8.7
Banking system	-0.2	-0.2
IFI's, net	-1.1	-4.6
Public sector, net	-0.4	1.6
Other, net	3.2	1.5
Reserves change	**5.3**	**-4.5**

Note: [1] Net exports settled in the local market (MULC) are usually larger than the headline number. The latter includes trade not settled in the local market.
Source: Barclays Capital

abundant FX. Furthermore, low global interest rates, strong capital flows towards emerging markets, and a relatively stable domestic economy should also contribute to diminished capital outflows (at least relative to 2010). As a result, we expect the drop in international reserves to be only marginally higher than the payment that we expect will need to be made to the Paris Club. In summary, the central bank is likely to continue buying dollars in the market, preventing an even stronger real appreciation, and eventually transfer the acquired hard currency to the Treasury.

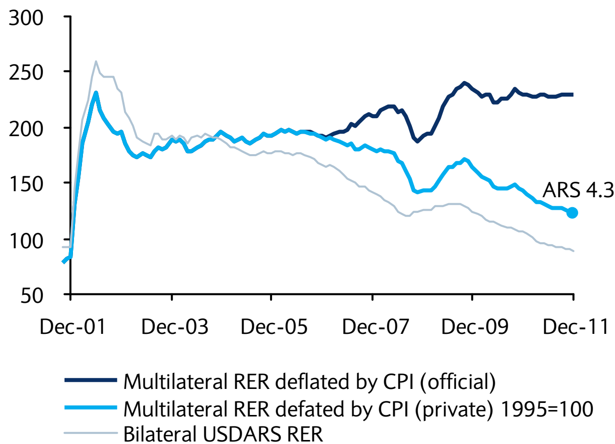
The central bank is expected to provide the bulk of financing to the government

The results of the central bank policies are likely to yield a relatively stable nominal exchange rate and deterioration in the quality of the central bank balance sheet. We expect the peso to slide by roughly one-third to one-half of the domestic inflation rate. At times, the slide in the currency will be forced by the need to replenish reserves. At other times, particularly in Q3 as the country enters the home stretch of the electoral period, we expect the central bank to provide as many dollars as demanded by the market to prevent swift movements in FX. A central aim throughout the year will be to maintain a high level of reserves while preserving stability in domestic money demand. The latter requires, in the central bank's view, limited volatility, though not necessarily a constant exchange rate.

Many of the new policy initiatives are expected to be related to the debt

Argentina's standing with markets in 2011 will depend on the fate of a number of initiatives. In November, the government announced its intention to resolve its default to the Paris Club. While there is no timeline for such a resolution, the authorities have indicated they will initiate more formal conversations during December and that they expect an agreement to be completed by the end of Q1. We expect markets to be significantly more sensitive to an agreement than to the nature of the deal, even if it is significantly front loaded and absorbs a chunky fraction of reserves. The government has also announced it has requested technical support from the IMF to construct a new CPI with wider coverage. Given the questions surrounding Argentina's statistics, a rapid IMF involvement in their improvement could prove another important development for the republic. Also, Argentina remains willing to conduct some liability management transactions that could improve its liability profile. To the already-announced continued reduction in market holdings of debt (through net payments of debt), the authorities could implement some of the strategies of currency redenomination and maturity extension that have been under study for a while.

Figure 5: Real exchange rate appreciation to continue



Note: We use the house CPI and FX forecasts for trade partners.
Source: Barclays Capital

Figure 6: The central bank to carry the brunt of financing

	2010E	2011F	2012F
Gross financing needs	11.5	18.9	16.8
Interests + GDP warrants[1]	4.4	6.9	6.9
Principal	4.5	6.0	4.3
Paris Club (expected)		3.5	3.0
IFIs and other	2.6	2.6	2.5
Provinces gap	3.3	3.5	3.5
Primary deficit	1.5	2.3	2.2
Other resources[2]	-5.4	-3.0	-3.2
Net financing needs	10.9	21.7	19.3
Financing sources	-13.0	-19.2	-8.6
Public sector financing[3]	-4.4	-4.1	-3.6
IFIs rollover (IADB/WB/CAF)	-2.0	-2.0	-2.1
Use of reserves to pay debt	-6.7	-7.5	
Use of reserves to pay Paris Club		-3.5	-3.0
Cash		-2.1	
Financing gap	-2.1	2.5	10.7

Note: [1] GDP warrant payments are estimated at 2.6bn in 2011. [2] Includes central bank capital gains (2.0bn) and ANSES rents. [3] Includes Banco Nacion, central bank lending to the treasury, and rollover of public sector government bond holdings, mainly of ANSES and Central Bank.
Source: Mecon, Central Bank, ANSES, Barclays Capital

A broad range of Argentine issuers are expected to return to the bond and equity markets

We expect a number of issuers returning to the markets in 2011. Our estimates of financing needs for the sovereign suggest USD2.5bn could come to market (either through ANSES selling its holdings or through primary issuance). We also expect USD2bn of global issuance by provinces, which in 2011 would deepen their budgetary needs and reliance on central government financing. Finally, we expect growing interest on the part of Argentine corporates to increase their market presence. We also expect greater activity in the equity market, in line with Repsol's recently announced sale of shares.

In short, from a strategic perspective, we continue to favour holding exposure to Argentina and maintain a target of 550bp in 5y CDS.

Figure 7: Macroeconomic forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	8.7	6.8	0.9	8.9	5.3	3.7
Domestic demand contribution (pp)	9.8	8.5	-1.0	10.6	6.7	4.2
Private consumption (% y/y)	9.0	6.5	0.5	8.6	7.1	4.0
Fixed capital investment (% y/y)	13.6	9.1	-10.2	14.1	5.7	4.2
Net exports contribution (pp)	-1.2	-1.7	1.8	-1.7	-1.5	-0.5
Exports (% y/y)	9.1	1.2	-6.4	14.8	5.3	4.6
Imports (% y/y)	20.5	14.1	-19.0	30.9	15.6	7.2
GDP (USD bn)	261	327	307	399	508	579
External Sector						
Current account (USD bn)	7.1	7.1	11.3	5.3	-0.2	-3.8
CA (% GDP)	2.7	2.2	3.7	1.3	0.0	-0.7
Trade balance (USD bn), FOB	13.3	15.5	18.5	15.4	9.2	5.6
Net FDI (USD bn)	5.0	8.3	3.2	3.3	3.5	5.0
Other net inflows (USD bn)	2.1	-15.2	-12.9	-3.3	-7.8	-1.1
Gross external debt (USD bn)	124.6	128.1	133.2	138.6	144.1	149.9
International reserves (USD bn)	46.2	46.4	48.0	53.3	48.9	49.0
Public Sector						
Public sector balance (% GDP) **	0.0	0.9	-2.5	-1.7	-1.8	-1.6
Primary balance (% GDP) **	2.0	2.7	-0.4	-0.4	-0.5	-0.4
Gross public debt (% GDP)	55.5	44.6	47.9	39.3	32.8	31.0
Prices						
CPI (% Dec/Dec) *	25.7	23.0	14.8	25.2	28.0	26.9
CPI (% average) *	18.4	26.7	16.3	22.1	26.9	27.8
Exchange rate (ARS/USD, eop)	3.15	3.45	3.80	4.00	4.30	5.26
Exchange rate (period average)	3.12	3.16	3.73	3.90	4.15	4.78
	1y ago	**Last**	**Q4 10F**	**Q1 11F**	**Q2 11F**	**Q3 11F**
Real GDP (% y/y)	-0.8	11.8	7.9	6.2	4.4	5.4
CPI (% y/y, eop) *	17.0	21.5	24.9	25.8	26.6	27.2
Exchange rate (ARS/USD, eop)	3.80	3.98	4.00	4.05	4.07	4.15
Benchmark rate (%, eop), BADLAR	10.2	10.8	10.5	10.5	11.0	11.5

Note: * Private estimate, differs with official inflation. ** Excludes central bank profit transfers, rent transfers of the nationalized pension fund system (FGS) and reserves to pay debt transfers of the central bank. Source: Barclays Capital

LATAM: BRAZIL

Constraining the necessary adjustment

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BCB started to tighten monetary conditions in December, but still has a long way to go to rein in inflation expectations. With limited help from the fiscal side – and large constraints to surpass – we believe the bank will have to continue tightening and will start hiking rates in March 2011. However, our main concern is that policy slippages could drive inflation above the target range in 2011 and allow it to stay at a high level.

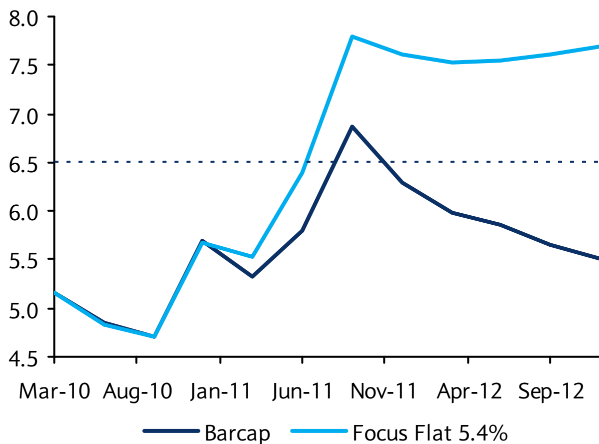
The new BCB takes office having to rein in inflation expectations.

President-elect Dilma Rousseff will be inaugurated on January 1, 2011. We expect continuity, especially regarding fiscal policy, as Finance Minister Mantega will retain his post. We also believe some expenditure trimming is due, following the excesses generated by the countercyclical policies that were not unwound, as well as this year's electoral cycle splurge. However, we do not expect such a significant change in the fiscal stance that it would influence the fiscal/monetary policy mix. To be sure, BCB already inaugurated its second leg of tightening through a set of macro-prudential measures that range from reserve requirements hikes to an increase in capital requirement for household loans. In this sense, monetary policy will continue to bear the burden of the adjustment. But the question is, how much of the necessary adjustment will this new administration be willing to impose? And our view is that there are binding constraints that will limit the Monetary Authority's drive to pursue the mid-point of the inflation target in the foreseeable future.

The new BCB President Alexandre Tombini starts with a full slate. He will have to muster the political support to continue tightening monetary conditions but now through Selic rate hikes. This is a necessary condition to manage expectations and maintain inflation within upper level of the target range. We have revised our monetary policy forecasts expecting the BCB to hike rates in March. While we do not discount a possible January move, this should only happen if inflation (observed and expectations) continue to deteriorate. The full tightening cycle should amount to 150bp, lifting the Selic rate up to 12.25% by June (three consecutive 50bp hikes).

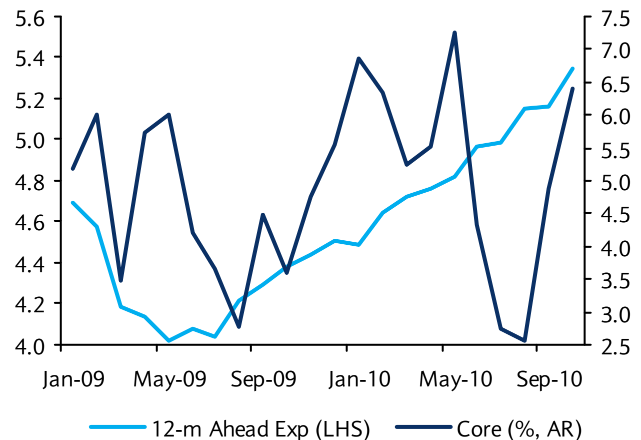
Figure 1 shows two simulations, our base case forecast for inflation and what the outcome would be if the BCB held rates steady at 10.75% and inflation expectations remain at 5.4%.

Figure 1: IPCA simulations should no convergence in sight …



Source: IBGE, Barclays Capital

Figure 2: …with broader pressures lifting expectations



Note: *Core: annualized average of the three measures tracked by the BCB.
Source: IBGE, Barclays Capital

We expect rates to start rising only in March and the BCB to deliver a 150bp tightening cycle, less than the 200bp priced in the curve

The picture speaks for itself and shows how critical it is to rein in inflation expectations in order to meet the targets. In our base case scenario, inflation remains resilient, rising temporarily above the target range in Q3 11 (base effects) to close the year a tad below the upper range at 6.3%. The outlook for food prices, once again, should play a critical role in the expected path of inflation. And even if our 8.0% forecast for food inflation proves too high, given that the underlying pressures are more broad-based (Figure 2), attaining convergence to the mid-point of the target over the next two years will be very difficult. Hence, we believe the risk remains that inflation could crystallize at about the 5% level for much longer than we had previously expected.

Even with the tightening we expect, inflation should rise in 2011 to 6.3% and later crystallize at 5.0-5.5%; we see a material risk that the BCB misses its target in 2011

There are important constraints that we believe will limit the BCB's capacity to act decisively in pushing inflation closer to the mid-point of the target range next year. The first remains global economic uncertainty. The risks that new waves of macroeconomic stress arise from the south of Europe, from the political front in the US or even from China should continue to keep a dovish bias among global policymakers.

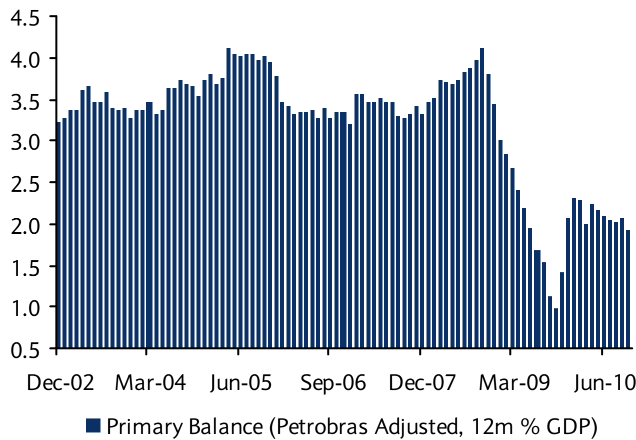
President-elect Rousseff's attempt to force a tighter coordination between fiscal and monetary policy and Minister Mantega's recent change in speech, favouring more fiscal austerity, should also help postpone an imminent hike in interest rates. Given that the BCB signalled in the last minutes of the Copom meeting the conditionality of future monetary policy action on further fiscal and credit restraint, it is likely that the BCB will wait for the next steps on the fiscal/public credit side before hiking rates. And the decision to start tightening monetary conditions first through reserve requirement is to us a clear signal in this direction.

We believe there are important constraints that should limit the BCB's drive to bring inflation back to the mid-point of the target

Finally, there is still the BRL constraint that should continue to weigh on the bank's decisions. Hiking rates would add pressure to the already high interest rate differential, boosting the Brazilian carry trade (exactly the situation that Minister Mantega has been combating with the IOF tax hikes). Although the recent bout of Southern European sovereign jitters has pressured the BRL, relaxing the restrictiveness of this constraint, it remains an important issue for the BCB.

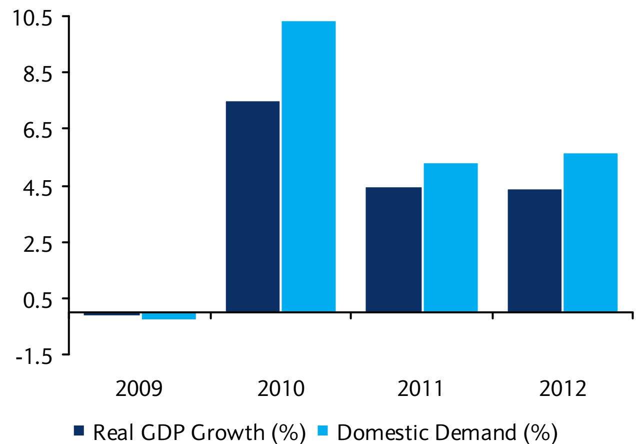
Communications from the December Copom meeting, as well as the 4Q Inflation report, should give us some indication of how the new BCB will likely be conducting this second leg of tightening.

Figure 3: No fiscal exit strategy



Note: Primary surplus excluding one-off Petrobras recapitalization revenue.
Source: BCB, Barclays Capital

Figure 4: Domestic demand outpacing real GDP growth



Source: IBGE, Barclays Capital

Some fiscal adjustments are due, but not enough to prevent interest rate hikes

A significant part of the need to continue tightening monetary policy reflects the absence of exit strategies on the fiscal side. Figure 3 plots the primary surplus adjusted for Petrobras' extraordinary revenue last September. The fiscal policy stance remains very loose, and compared with the 3.5% pre-crisis average, apparently government savings shifted down on a permanent basis. But despite the deterioration, markets should remain at ease with the country's fiscal solvency outlook. To be sure, we expect the government to continue delivering a primary surplus below the target but above 2.5% of GDP until 2012, which is sufficient to bring net debt to GDP down to 38.8% in 2012. But with another capital infusion to BNDES from the National Treasury (we expect more R$50bn next year), the gross debt should remain under pressure. After falling to 66.6% GDP in 2010 (from 68.6% in 2009), we expect the gross debt to rebound to 67.7% next year and remain at 67.4% in 2012. Hence, the slowdown of government expenditure growth in 2011 to close to 8% from nearly 17% in 2010 will not be able to raise government savings to even close to the pre-crisis amount, meaning that the stance of fiscal policy will likely remain loose.

Domestic absorption should continue to outpace real GDP growth…

Domestic demand remains on a roll and should continue to outpace real GDP growth in 2011, although at a more modest pace than in 2010 (Figure 4). The marginal contribution of private consumption starts to soften as the real wage mass growth slows from 7.2% this year to 4.9% and 3.4% in 2011 and 2012, respectively. But low unemployment rate and supportive credit conditions should keep domestic absorption afloat. And the discrepancy between retail sales and industrial production during 2010 (Figure 5) should also start to diminish as the domestic industry finalizes its inventory cycle and reacts to the strength of domestic demand. But imports will continue to play an important role in filling the gap between domestic supply and demand and preventing inflation from rising at an even faster pace.

… and the CA deficit will likely continue to widen

Finally, the balance of payments outlook laid out in our previous *The Emerging Markets Quarterly* remains intact. Strong import growth, along with large profit and dividend remittals and rising travel expenses, continues to lead the deterioration of the current account deficit. We now expect it to widen to 2.9% of GDP in 2010 from an expected 2.5% and 3.1% in 2011 and 2012, respectively.

The significant gains in terms of trade (Figure 6) are preventing a faster pace of trade deterioration, but we do not expect the same benefit in the few next years. We expect trade to dip into negative territory in 2012 (-USD1.2bn) for the first time since 2000. Although

Figure 5: Imports help bridge the gap

Source: Funcex, IBGE, Barclays Capital

Figure 6: Very high ToT help mitigate trade deterioration

Note: Ratio between export and import prices. Source: Funcex, Barclays Capital

external financing remains well placed, with the pickup in FDI and portfolio flows more than compensating for the CA deterioration, the latter comes at a price of larger dependence on external savings.

The USD/BRL should remain range-bound between 1.65 and 1.70 in the near to intermediate term

The USD/BRL exchange rate will remain pulled by conflicting forces: global liquidity and carry (helped by the upcoming tightening cycle) are pushing the rate down, while the fear of intervention and concerns about global tail events should pressure it in the opposite direction. Hence, our view is that in the near to intermediate term, the USD/BRL should be range-bound between 1.65 and 1.75. As we move into 2011, we expect the appreciating forces supporting the BRL to prevail and the exchange rate to retest the 1.65 level. But we have seen this movie before, and it should have the same ending: more intervention, a higher cost for Treasury financing and limited BRL depreciation.

Figure 7: Brazil macroeconomic forecasts

	2005	2006	2007	2008	2009F	2010F	2011F	2012F
Activity								
Real GDP (% y/y)	3.2	4.0	6.1	5.1	-0.2	7.5	4.5	4.4
Domestic demand contribution (pp)	2.7	4.9	7.2	7.2	-0.3	10.3	5.3	5.7
Private consumption (% y/y)	4.5	5.2	6.1	7.0	4.1	6.2	4.4	5.2
Fixed capital investment (% y/y)	3.6	9.8	13.9	13.4	-9.9	21.8	11.2	10.2
Net exports contribution (pp)	0.5	-0.9	-1.1	-2.1	0.1	-2.8	-0.8	-1.3
Exports (% y/y)	9.3	5.0	6.2	-0.6	-10.3	8.9	6.4	3.1
Imports (% y/y)	8.5	18.4	19.9	18.0	-11.4	35.1	11.1	11.0
GDP (USD bn)	882	1089	1367	1636	1577	2007	2354	2580
External sector								
Current account (USD bn)	14.0	13.6	1.6	-28.2	-24.3	-51.0	-67.9	-80.2
CA (% GDP)	1.6	1.3	0.1	-1.7	-1.5	-2.5	-2.9	-3.1
Trade balance (USD bn)	44.7	46.5	40.0	24.8	25.3	18.1	7.6	-1.2
Net FDI (USD bn)	12.5	-9.4	27.5	24.6	36.0	23.5	29.0	33.0
Other net inflows (USD bn)	-22.7	24.8	60.8	3.7	34.1	73.5	48.5	53.5
Gross external debt (USD bn)	169.5	172.6	193.2	198.3	198.2	254.3	265.3	274.7
International reserves (USD bn)	53.8	85.8	180.3	193.8	238.5	290.6	300.3	306.7
Public sector								
Public sector balance (% GDP)	-3.5	-3.7	-2.8	-1.9	-3.4	-2.5	-2.9	-3.1
Primary balance (% GDP)	3.8	3.1	3.3	3.5	2.0	2.9	2.8	2.6
Gross public debt (% GDP)	67.7	65.7	64.4	63.6	68.6	66.6	67.7	67.4
Net public debt (% GDP)	48.2	47.0	45.1	38.4	42.8	40.0	39.4	38.8
Prices								
CPI (% Dec/Dec)	5.7	3.1	4.5	5.9	4.3	5.7	6.3	5.5
CPI (% average)	6.9	4.2	3.6	5.7	4.9	5.0	6.0	5.8
Exchange rate (BRL/USD, eop)	2.34	2.14	1.78	2.31	1.74	1.75	1.65	1.71
Exchange rate (period average)	2.41	2.17	1.93	1.83	1.99	1.77	1.67	1.68
	1y ago	**Last**	**3Q10F**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**	**4Q11F**
Real GDP (% y/y)	-0.2	8.8	6.8	5.6	4.2	4.0	4.8	4.9
CPI (% y/y, eop)	4.2	5.2	4.7	5.7	5.3	5.8	6.9	6.3
Exchange rate (BRL/USD, eop)	1.76	1.70	1.69	1.75	1.70	1.65	1.65	1.65
Monetary policy benchmark rate (%, eop)	8.75	10.75	10.75	10.75	11.25	12.25	12.25	12.25
Market implied benchmark rate (%,eop)	--	--	--	11.26	12.15	12.55	12.68	12.7

Source: IBGE, BCB, National Treasury, Barclays Capital

LATAM: CENTRAL AMERICA AND THE CARIBBEAN

An improving region

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Central America and the Caribbean countries (CAC), as is the case with most emerging economies, are surprising the market to the upside this year with healthy economic growth and an improvement in the fiscal accounts in most of them, with the exception of Costa Rica. External accounts remain stable, with FDI and multilateral organizations providing a secure source of financing. Our favorite country continues to be the Dominican Republic, since, in our opinion, Panama's successful history has been priced in. Given the weaker-than-expected fiscal figures in Costa Rica, we feel more comfortable recommending that investors reduce exposure. Although El Salvador and Jamaica are improving, we are still worried about their fiscal path, and recommend that investors maintain a low exposure to these countries.

Continues growing well

The Dominican Republic is still the big positive surprise of the region. On the other hand, Costa Rica is growing at a lower-than-expected pace

As is the case with most emerging market countries, the CAC group surprised the market to the upside this year. The big surprise has been the Dominican Republic, with an expected growth of 7.9% for 2010; since Panama was already viewed by the market as a fast-growing economy. The market has been much more cautious regarding the Dominican Republic. Nevertheless, we have had a bullish view on this country for some time now, based on an important increase in telecommunication, a positive defence position in tourism, a sector that it is contracting in CAC (more expensive places in the Caribbean have been replaced with cheaper ones, such as those in the Dominican Republic), and the reconstruction in Haiti, coupled with the important investment of developing the Pueblo Viejo gold mine. Based on this outlook, we think Dominican assets should continue to outperform the market. In the case of Costa Rica, growth was lower than our expectation and more in line with the market. Again, El Salvador and Jamaica have surprised us to the downside, supporting our bearish view on both countries. For 2011 and 2012, in general, we have a positive view about the economic growth in the region, passing from an average of 3.9% in 2010 to 4.5% average growth in 2011. Most analysts broadly assume that the CAC GDP will grow at a slower pace in 2011. In our opinion, despite unemployment in the US remaining high (low remittances), and external demand not growing at a fast pace; there are other variables that will help maintain, and in many cases, accelerate growth, i.e., the money from multilateral organizations will keep entering these economies.

Figure 1: High economic growth moderated inflation

	GDP Growth (%, y/y)				Inflation (%)			
	2009	2010	2011	2012	2009	2010	2011	2012
Dominican Republic	3.5	7.9	9.0	8.0	5.8	6.8	6.2	6.0
Panama	2.4	6.3	6.9	7.8	2.4	3.6	3.1	2.6
Costa Rica	-1.1	4.1	4.2	5.0	7.8	4.8	5.8	6.1
El Salvador	-3.5	1.5	1.3	2.3	-0.2	2.3	1.5	3.0
Jamaica	-3.3	-0.5	1.2	1.5	10.2	11.5	8.5	8.0
Average	**-0.4**	**3.9**	**4.5**	**4.9**	**5.2**	**5.8**	**5.0**	**5.1**

Source: DR, SLV, JAM, CRI, GTM central banks, Panama's statistics office of comptroller, Barclays Capital

With the exception of Costa Rica, inflation will continue its downward trend

In the region, price behaviour has shown mixed signs, but we have to say that most of the countries maintained low and manageable levels. By manageable, we mean all countries have kept inflation under two digits, Jamaica being the only one which registered a high figure of 10%. Our outlook for the next two years is positive. We expect all countries in the region, except Costa Rica, to show a better inflation performance than this year. This is mostly because the environment will allow them to focus on economic policy and controlling the increase in prices, instead of fighting the crisis. We think that Costa Rica (5.8%) will be the only country to show higher price increases, due to policy makers being willing to sacrifice some inflation for more economic growth, but without inflation returning to its old pace.

External accounts looks stable, and could be financed through multilaterals, new issuances and FDI

On the other hand, part of the pressure on inflation is due to higher commodity prices, which are also negatively affecting the current account. Nonetheless, the average current account deficit remained below the level reached in 2008 (a deficit of -10.9%) at -5.9% of GDP for 2010 and -5.7% of GDP for 2011. In the Dominican Republic, Costa Rica, and Panama, the current accounts deficits are being backed by foreign direct investment (FDI), which guarantees a stable source of financing. In addition, tourism and remittance will likely keep recovering slowly, and the same will likely happen with exports, whereas the imports should continue to grow quicker, deepening external imbalances, especially in the fastest growing economies.

Figure 2: Current account deficit mostly backed with FDI

	Current Account (% of GDP)				FDI (% GDP)			
	2009	2010	2011	2012	2009	2010	2011	2012
Dominican Republic	-7.9	-6.1	-6.4	-6.9	4.4	4.8	5.2	4.0
Panama	0.0	-4.2	-5.8	-4.4	7.3	8.2	10.0	10.6
Costa Rica	-1.8	-5.1	-4.7	-4.5	4.6	4.7	5.9	5.7
El Salvador	-1.8	-4.1	-4.2	-5.0	1.4	1.6	2.1	2.9
Jamaica	-9.0	-10.0	-11.5	-13.3	3.8	3.5	4.5	4.8
Average	**-4.1**	**-5.9**	**-6.5**	**-6.8**	**4.3**	**4.5**	**5.5**	**5.6**

Source: DR, SLV, JAM, CRI, GTM central banks, Panama's statistics office of comptroller, Barclays Capital

Some fiscal reforms and a good rate of growth will help countries improve fiscal figures

However, this should not be a big concern, in our view, since, on the fiscal side, most countries in the region are making great efforts on structural reforms in tax collection, and are behaving prudently with public spending (albeit opportunely with a still-expansive policy), thanks to the advice of the IMF, IADB and WB. All countries will likely show a fiscal deficit next year, because they will need to keep relying on government expenditure to support economic growth, since the recovery of the global economy and the international markets will likely be a bit weak. The country that could worsen more on the fiscal front is Costa Rica, as its deficit will be close to 4.8%, much higher than last year, but this should not create much concern for the markets.

Figure 3: Improving fiscal accounts

	Fiscal balance (% of GDP)				Primary Fiscal balance (% of GDP)			
	2009	2010	2011	2012	2009	2010	2011	2012
Dominican Republic	-3.2	-3.2	-2.6	-2.0	-1.4	-0.9	-0.3	0.0
Panama	-1.0	-0.6	-0.8	-0.7	2.1	2.9	2.7	2.8
Costa Rica	-3.0	-4.8	-2.8	-1.2	-0.8	-2.5	-0.2	1.7
El Salvador	-5.6	-4.8	-3.8	-3.2	-3.0	-2.5	-1.5	-0.8
Jamaica	-10.8	-7.5	-6.5	-5.5	-4.0	-3.6	-3.6	-2.5
Average	**-4.7**	**-4.2**	**-3.3**	**-2.5**	**-1.4**	**-1.3**	**-0.6**	**0.2**

Source: DR, SLV, JAM, CRI, GTM central banks, Panama's statistics office of comptroller, Barclays Capital

For 2011, a stronger dynamic in the economies, along with an improvement in the tax collection, will also allow the governments to increase their fiscal revenues. This is the case with Panama, Costa Rica, and Dominican Republic, which we project will have a fiscal deficit of 0.8%, 2.8%, and 2.6% respectively. This trend of a lower fiscal deficit will likely continue in 2012, as the economies in the region become stronger, leading us to improve the debt figures in all of the countries.

Better fiscal figures will improve the external debt path in terms of the GDP and in government revenues

We expect all the CAC countries to keep the downtrend they have been showing in their external indebtedness levels, as a share of GDP and of fiscal revenues. Something worth mentioning is that even though Costa Rica has shown a low level of external debt in terms of GDP, if we look at the total debt in terms of GDP, we see it is approaching a risky level because of a high internal indebtedness. Although we believe, as Moody's also said in its report regarding the upgrade to investment grade, that Costa Rica will keep managing down this indicator in 2011 and in 2012, we prefer to recommend that investors reduce exposure to Costa Rica.

Figure 4: Better-than-expected performance on debt indicators

	External Debt (% of GDP)				Debt (%Fiscal Revenue)			
	2009	2010	2011	2012	2009	2010	2011	2012
Dominican Republic	17.6	17.6	16.8	16.5	207	189	178	173
Panama	41.7	41.9	41.1	40.5	179	180	166	170
Costa Rica	11.7	11.4	11.1	10.8	319	314	319	303
El Salvador	31.0	33.2	34.9	35.4	358	400	450	498
Jamaica	52.8	46.5	44.8	43.5	443	452	434	420
Average	31.0	30.1	29.7	29.4	301	307	309	313

Source: DR, SLV, JAM, CRI, GTM central banks, Panama's statistics office of comptroller, Barclays Capital

We maintain our recommendations on DR, Panama, El Salvador, and Jamaica. We feel more comfortable with a Market Weight for Costa Rica

In this framework, with the exception of Costa Rica, which has had weaker-than-expected fiscal figures, we maintain our recommendation to increase exposure on the Dominican Republic, the fastest-growing economy in the region. We think Panama's successful history has been priced in. For the cases of Jamaica and El Salvador, although El Salvador had a slightly more positive fiscal performance than we expected, we still recommend investors to maintain an Underweight out of these countries.

LATAM: CHILE

Nothing to fear but fearlessness itself

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We look for another strong year for growth with, in principle, contained inflation. Our only concerns entail potential policy mistakes on the fiscal and monetary fronts leading to an overheating. We continue to like the peso but upside potential has moderated

Strategy: We continue to like CLP investments but upside potential has moderated, in our view. In the rates space, we recommend long-end receivers, especially in real rates.

Another strong year

We expect further support from strong terms of trade and lingering policy stimulus…

We expect the Chilean economy to continue growing above trend in 2011. On the external side, based on our Commodity Research colleagues' projections, terms of trade will probably remain very supportive for a couple of more years (Figure 1). On the domestic side, monetary and fiscal policy, while not as overwhelmingly expansionary as in 2010, are still, and will probably remain, accommodative for most of 2011 (Figure 2).

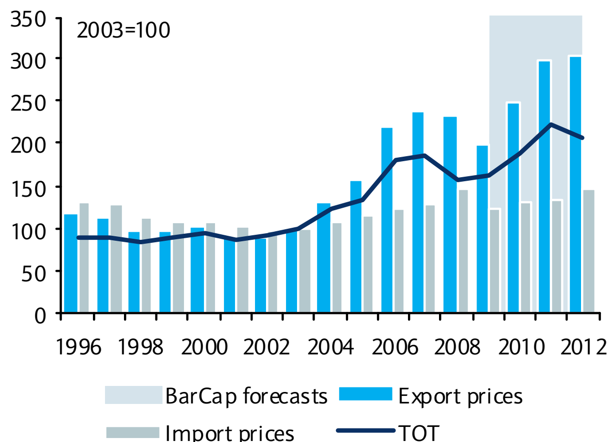
…with some compensation from currency strength

That said, we have scaled back our forecast for growth next year to 6.1% from close to 7%. This is, in part, because the recovery from the earthquake was more front-loaded than we anticipated (we track a 5.4% headline reading for overall growth in 2010), and, in part, because currency strength seems to be having a fairly chilling effect on manufacturing activity, even as domestic demand growth should be a source of support. Our forecast is consistent with a 5.0% q/q saar pace of expansion during 2011, with the headline reading helped by a sizable carry-over.

Output gap metrics point to incipient overheating

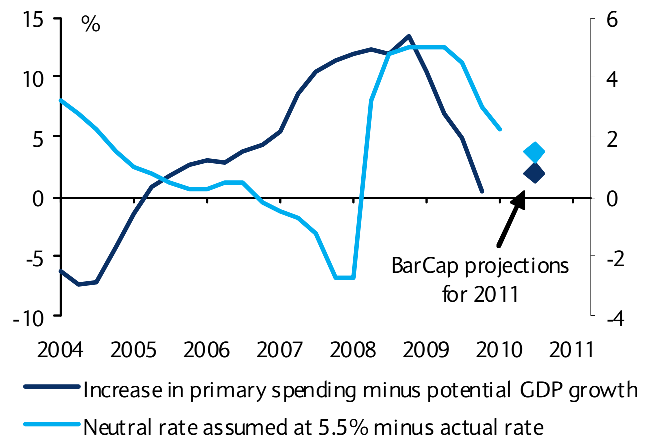
This pace of expansion is consistent with incipient overheating next year, in our view, given the rapid closure of the output gap so far, evidenced by historical trend metrics, as well as the unemployment rate (Figures 3 and 4). While our baseline scenario is for this development not to translate into an above-target inflation rate, given the very low underlying inflation trend going into year-end, overheating and inflation seem to us the greatest risks in 2011.

Figure 1: Supportive terms of trade for longer



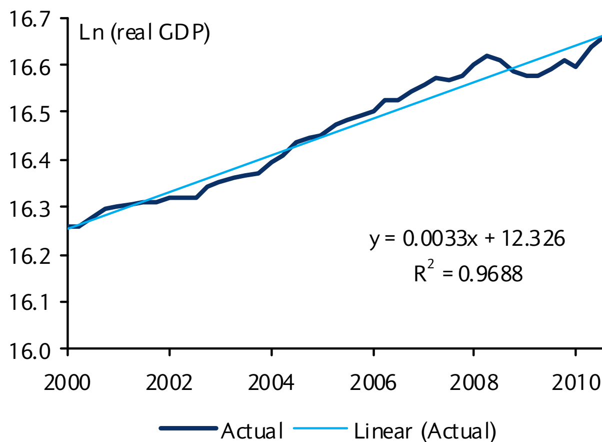
Source: Haver Analytics, Barclays Capital

Figure 2: Metrics of policy stimulus



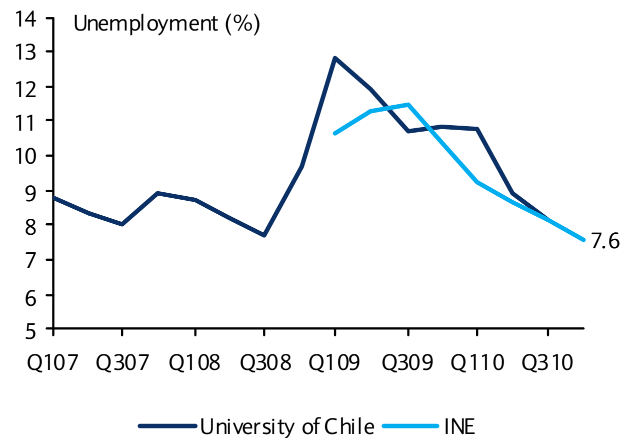
Source: Haver Analytics, Barclays Capital

Figure 3: GDP close to potential



Source: Haver Analytics, Barclays Capital

Figure 4: Unemployment back to pre-crisis levels



Source: University of Chile, Barclays Capital

Risks of policy mistakes

There are some reasons why macro policy might err on the loose side

We believe the fiscal and monetary authorities are aware of the risks at stake and will stick to the country's traditionally responsible management of macroeconomic policy. However, there are reasons that can cause them to err on the looser side, in our view.

Regarding fiscal policy, we highlight two risk factors. First, as we described in the previous edition of *The Emerging Markets Quarterly*, we believe the political economy of the current administration makes it easier for the government to execute a looser fiscal stance, as the recent endorsement of the 2011 budget by the left-leaning opposition exemplifies.

The cycle is not the trend

Second, since taking office, the government has actively engaged in an agenda to boost potential GDP growth – a central campaign promise – adopting a series of productivity-enhancing measures (Figure 5); although this is by all means a welcome development, we think it hints at some risk that the authorities might mistake a cyclical increase in output as a potential gain and calibrate fiscal policy incorrectly. Of course, assessing changes in potential GDP growth in real time is a challenge, but we find it noteworthy that the

Figure 5: Aiming at increasing productivity

Date	Measure
16-Apr-10	Announcement of public investments of USD8.4bn toward public infrastructure
15-Jul-10	"Chile's Day" begins in NY with measures toward private funding
4-Aug-10	Measures regarding derivatives are supposed to provide liquidity to this market
12-Aug-10	Committee created to revise the institutional model for regulation on financial markets
3-Sep-10	Minister of Finance and Banco Estado launch credit program for small and medium enterprises
8-Sep-10	Measures to get SMEs to use FX covering
9-Sep-10	Plan unveiled to boost Chile's position in competitiveness rankings
22-Sep-10	Announcement of improvements in financial contracts, aiming at protecting the consumer and enhancing competition
20-Oct-10	New measures announced, benefiting exporters via costs and shipping duration reduction
23-Nov-10	Measures to improve corporate governance in state-owned enterprises
25-Nov-10	Tax reductions for agriculture producers to increase their competitiveness

Source: The Ministry of Finance, Barclays Capital

assumption for potential growth underlying the 2011 budget is 4.8% (well-above the 3.8% average in the 2000s), and the reported output-gap assumed to determine the fiscal stance has been positive in all the years since 2001 (Figure 6).

A new way of thinking in terms of the neutral policy rate

Regarding monetary policy, we believe the central bank is unlikely to be too sanguine about potential growth; indeed, we find it reassuring that the board did not display much complacency in response to the benign trajectory of inflation recently – see *Chile: BCCh does not lower the guard*, December, 1, 2010. However, we think BCCh has signaled a new way of thinking about the neutral policy rate – one much more sensitive to level of long-term rates overseas – and while this approach makes perfect theoretical sense (after all, in a world of perfectly mobile capital, the equilibrium interest rate is a function of the interest rate abroad), its appropriateness in the Chilean context is not guaranteed (because the degree to which capital flows freely is uncertain).

We continue to expect a pause at 4%

Overall, we think BCCh will continue normalizing the level of the policy rate, in response to the practical return to full employment observed in the past few months. However, we expect it to pause for some time at a rather expansionary level relative to pre-crisis estimates for the neutral range (5.1-6.5%). We maintain our baseline scenario for a pause to occur at 4% in March 2011, with risks tilted toward a somewhat higher level, given the non-reassuring output gap trajectory. We pencil in further normalization in 2012 toward 5.0%.

Moderate upside potential for the CLP

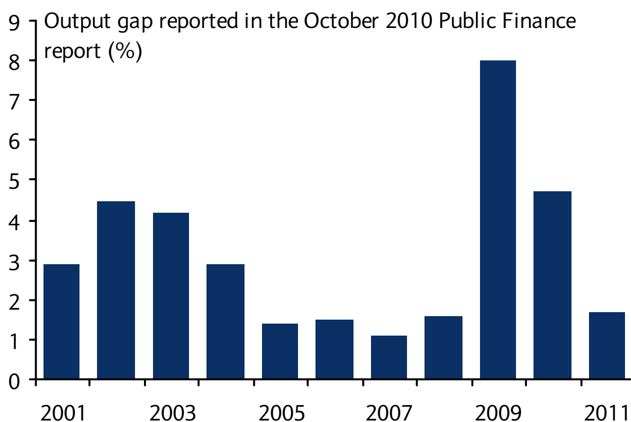
Upside has moderated but we still like the CLP

We continue to think that the combination of high copper prices, elevated growth, and some further normalization should bode well for ongoing currency appreciation. However, we highlight that the currency's upside potential has moderated markedly after the appreciation of recent months and given our less ebullient outlook for real GDP growth and the policy rate. We look for an appreciation to 465 in six months.

Intervention risks seem limited

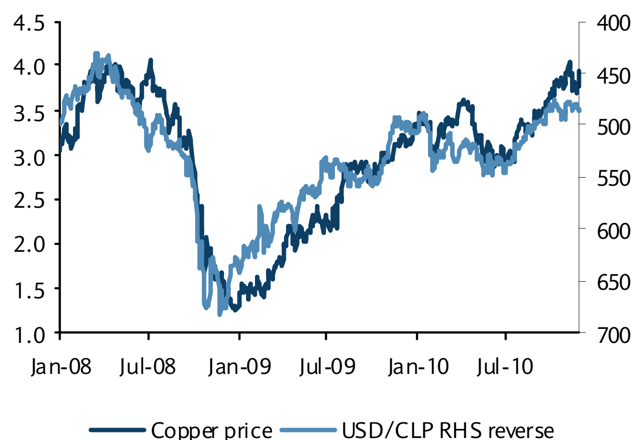
We do not envision dramatic intervention risks at this juncture, although if appreciation occurs fast and the central bank is close to a defensibly neutral level of the policy rate, we would not discard that course. Although we think the appreciation in the past six months and the soft figures from the manufacturing sector are concerns for the political authorities, we suspect their tolerance for a stronger FX seems a notch greater than in the previous government.

Figure 6: Can the output gap always be positive?



Source: The Ministry of Finance, Barclays Capital

Figure 7: Boosted by copper



Source: Haver Analytics, Barclays Capital

The authorities' vision is to take Chile to the developed country leagues, and this may lead them to view real appreciation as a natural by-product of the process. Their focus so far on enhancing productivity or alleviating the effect of appreciation rather than combating it supports this view (Figure 5.) While not advocating intervention, we note that the medium-term risks of this strategy again lie in the difficulty of discerning appreciation pressures stemming from higher productivity from those arising from a loose fiscal stance. For the moment, however, the government's tolerant attitude toward appreciation limits the downside risk of peso investments. There is, to sum up, little to fear but fearlessness itself.

Figure 2: Chile macroeconomic forecasts

	2007	2008	2009	2010P	2011F	2012F
Activity						
Real GDP (% y/y)	4.6	3.7	-1.5	5.4	6.1	4.5
Domestic demand contribution (pp)	7.8	8.1	-6.5	17.0	7.5	6.4
Private consumption (% y/y)	7.0	4.6	0.9	10.2	6.7	4.8
Fixed capital investment (% y/y)	11.2	18.6	-15.3	18.1	6.8	9.6
Net exports contribution (pp)	-3.2	-4.4	5.0	-11.6	-1.4	-1.8
Exports (% y/y)	7.6	3.1	-5.6	2.7	9.4	4.0
Imports (% y/y)	14.5	12.2	-14.3	28.8	9.2	6.1
GDP (USD bn)	164.5	170.4	164.0	204.3	237.6	259.2
External Sector						
Current account (USD bn)	7.5	-2.5	4.2	-1.8	6.5	1.9
CA (% GDP)	4.5	-1.5	2.6	-0.9	2.7	0.7
Trade balance (USD bn)	23.9	8.8	14.0	10.7	25.0	20.8
Net FDI (USD bn)	10.0	7.2	4.7	9.0	9.3	10.0
Other net inflows (USD bn)	-20.2	0.1	-7.2	-8.8	-18.3	-14.4
Gross external debt (USD bn)	55.7	64.3	74.0	85.1	93.7	103.0
International reserves (USD bn)	16.9	23.2	25.4	27.0	29.5	32.0
Public Sector						
Central government balance (% GDP)	8.8	4.8	-4.4	-1.0	-0.8	-0.9
Primary balance (% GDP)	9.4	5.3	-4.2	-0.7	-0.3	0.0
Gross central govt. debt (% GDP)	4.1	5.2	6.1	8.8	10.5	11.4
Net central govt. debt (% GDP)	-13.7	-20.4	-11.1	-7.2	-6.4	-5.5
Prices						
CPI (% Dec/Dec)	7.8	7.1	-1.4	2.8	3.0	3.1
CPI (% average)	4.4	8.7	1.5	1.4	2.2	3.4
Exchange rate (dom currency/USD, eop)	498	639	507	495	465	474
Exchange rate (period average)	522	524	559	510	480	470
	1yr Ago	**Last**	**Q410F**	**Q111F**	**Q211F**	**Q311F**
Real GDP (y/y)	2.1	7.0	6.2	9.2	5.7	5.0
CPI (% y/y, eop)	-1.4	2.0	2.8	1.9	1.8	2.6
Exchange rate (dom currency/USD, eop)	507	486	495	480	465	465
Monetary policy benchmark rate (%, eop)	0.50	3.00	3.25	4.00	4.00	4.00

Source: Haver Analytics, Barclays Capital

LATAM: COLOMBIA

Time to meet expectations

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We look for another year of solid growth performance in 2011, contained inflation pressures and no rates normalization before September. FX policy will preclude fast or sharp appreciation but, nonetheless, we do not expect current FX weakness to persist.

Strategy: We acknowledge the more difficult policy environment for the COP but think downside potential has dropped substantially at current levels and expect it to return to 1850 next year. We also like long-end rates after the recent sell-off.

Solid activity outlook

We look for another year of solid growth…

The Colombian economy will continue to recover at a solid pace, in our view. We forecast real GDP growth to reach 4.2% this year and 4.4% in 2011. This performance, supported by favourable terms of trade and a fairly expansionary policy mix, will be consistent with a further, slow narrowing of the output gap.

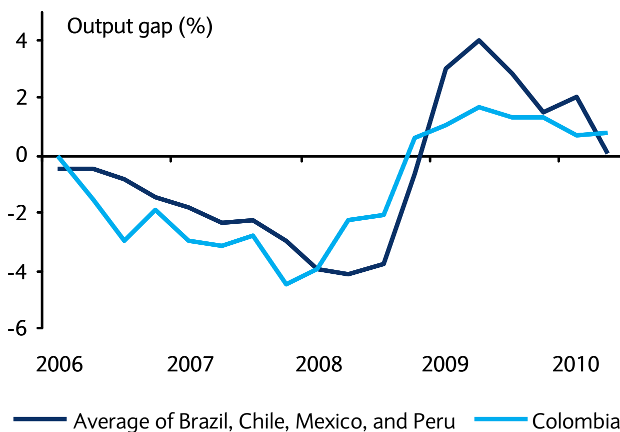
Colombia stands out among regional peers due to the shallowness of its 2009 recession as well as the slower pace at which its output gap is closing (Figure 1.) We believe the resilience of the economy during the crisis owed to its lower financial ties with the world. We think the slowness of the recovery reflects sluggish consumption in the US and Venezuela's (late) recession.

…but manufacturing will likely continue to underperform

Absent strong demand for Colombia's small set of non-traditional exports from its two main trading partners, manufacturing output is suffering more than during previous periods of currency strength, bringing down overall GDP growth. To counter this, the authorities have put in place a range of initiatives aimed at lowering peso strength (symptomatic in our view of Dutch disease), with (admittedly) much more success than we expected. However, we view this as an exercise in damage control rather than grounds for expecting a strong rebound of the manufacturing sector or an overall ebullient recovery (Figure 2).

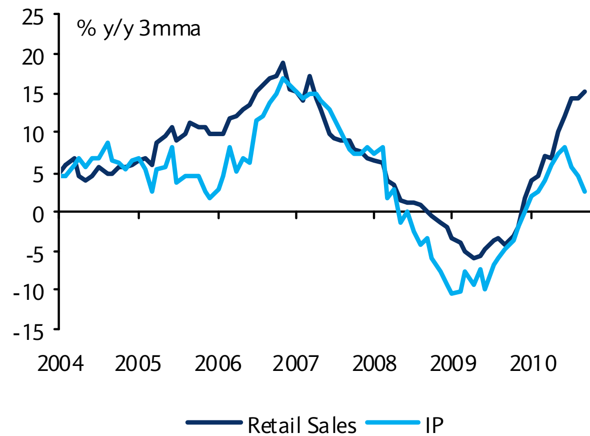
Although we forecast a slower pace of recovery than for other economies in the region (eg, Chile), we expect Colombia's to be less risky. According to our Commodity research

Figure 1: Shallower recession, less impressive bounce



Source: Haver Analytics, Barclays Capital

Figure 2: Retail sales and IP part ways



Source: Haver Analytics, Barclays Capital

colleagues, for example, current oil prices are still below potential long-term levels, limiting the downside risk from a terms-of-trade shock. Potential GDP growth also seems likely to be sustained by the still ample space for productivity gains in a number of sectors such as retail and finance. The environment for these gains to be exploited remains fertile, with this year's smooth political transition cementing the notion that macroeconomic and institutional stability are lasting achievements, along with regained security. Finally, the new administration's political capital and reform impetus suggest there can be reasonable hope of productivity-enhancing policies.

This symptom of Dutch disease is one of the main medium-term risks we envision…

The main risk to Colombia's medium-term outlook, in our view, is Dutch disease. This is certainly not an exclusive risk in a very commodity-oriented region, but it could be particularly problematic in a country at the lower end of the region's development ladder and with fairly high structural unemployment. However, as long as oil prices remain strong, we think this risk is a distant one.

Dutch disease meets antibodies

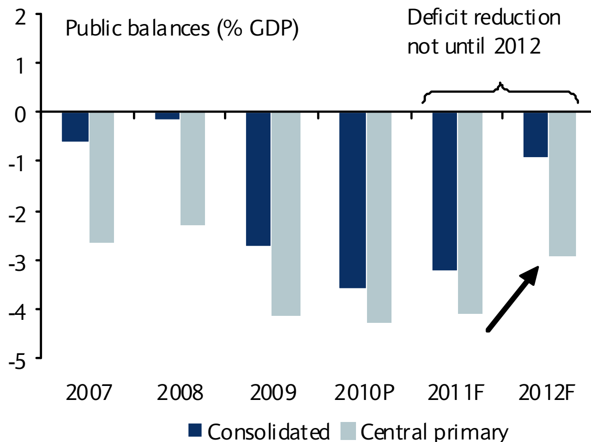
…and the authorities have also taken it very seriously

The government has taken currency strength very seriously, contrary to our expectations that it would aim to moderate the pace of appreciation rather than attempt to reverse the currency's course. In the past few months, the central bank has extended the intervention package announced in September for two months (*Colombia: Damocles-style intervention*, 29 October 2010) and the Ministry of Finance has announced a number of initiatives against currency strength (*Colombia: Complementary FX measures from Hacienda*, 2 November 2010.) Most recently, according to Bloomberg (24 November), the Ministry of Finance said it would provide more "ammunition" for the central bank to buy dollars – which we interpret as possibly signalling greater participation of the Treasury in debt issuance for sterilization purposes.

We think this limits the appreciation potential of the COP…

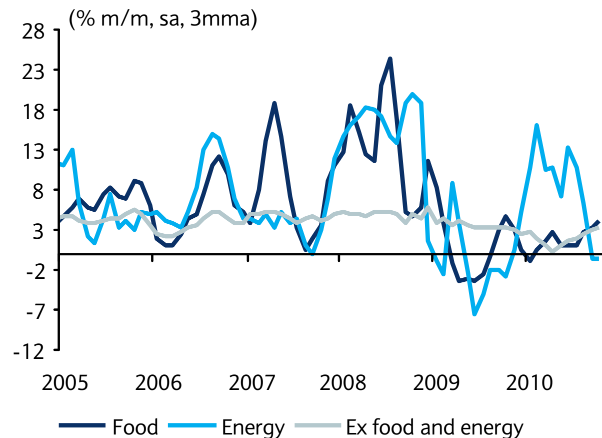
Against his backdrop, the COP has been a major underperformer among EMFX, in contrast to previous interventions. We believe that the discretionary component of the central bank intervention, the relentlessness of the announcements, and the intensity of the accompanying rhetoric have combined to result in a more effective overall policy package than we had envisioned. We do not think the government will lower its guard in this regard, making a significant or a fast appreciation unlikely, in our view.

Figure 3: Fiscal consolidation: easier said than done?



Source: Ministry of Finance, Barclays Capital

Figure 4: The underlying inflation trend has bottomed out



Source: DANE, Barclays Capital

…but do not expect current weakness to persist

That said, little has changed fundamentally for the currency and, if anything, the signals issued since the administration took office suggest that the fiscal consolidation pledged by the government, which could have caused a genuine depreciation of the equilibrium exchange rate, has been easier said than done. One of the first policy decisions of the administration was actually to increase the 2011 budget, leaving adjustment for 2012 (Figure 3.) Moreover, according to recent press reports and official confirmation, the government is entertaining the idea of selling 10% of its shares in Ecopetrol (close to USD10bn or 3% of GDP) to fund a colossal infrastructure agenda: all very good for long-term growth, possibly a good idea overall, but hardly compatible with a lower fiscal deficit or currency weakness.

We expect inflation to be well behaved, but not to decline as Banrep expects…

Meanwhile, inflation has remained well behaved in the past few months, largely in line with our expectations. The contribution of the different components to the CPI change has evolved in a meaningful manner, however. While energy inflation declined as lagged increases in regulated prices ran their course, there was a pick-up in both food and, crucially, core inflation at the margin. This pick-up in the underlying inflation trend is the main reason we do not share the central bank's baseline scenario that inflation will have a declining trend towards 2% next year. Instead, we expect it to end slightly above 3%, despite a favourable base in the energy component.

…leading the bank to begin normalizing rates in Q3

While not alarming, this outlook should gradually lead Banrep to switch gears from currency intervention to rates normalization, though we have pushed our forecast for the start of this process out to September, from April previously.

Time to deliver

Although the reform agenda is ambitious...

As we move into 2011, we think the market optimism triggered by the takeover of a patently reform-oriented administration enjoying great political capital will fade unless some tangible achievements become visible. As with fiscal consolidation, other proposed reforms by the government have proved less uncomplicated than may have been imagined (Figure 5).

…we expect progress to continue

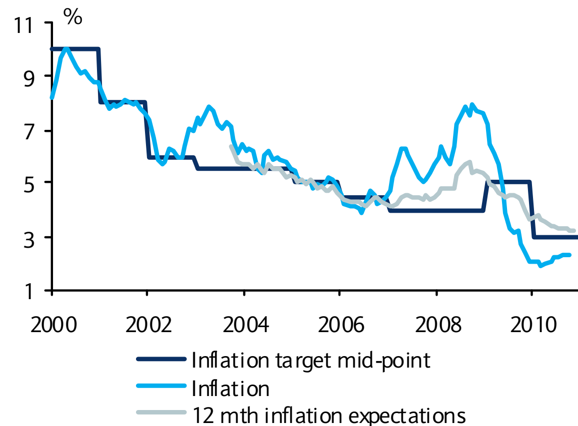
That said, we think progress on the reform agenda, even if not rapid, will continue. This, combined with solid growth and recent further evidence of a successful consolidation of the inflation targeting regime (Figure 6), should pave the way for quick attainment of an investment grade.

Figure 5: Progress on the reform agenda

	Start	1st	2nd	3rd	4th
Royalties (8 debates)	20-Jul	23-Sep	12-Oct	10-Nov	24-Nov
Fiscal sustainability (8 debates)	31-Aug	6-Oct	26-Oct	17-Nov	25-Nov
Fiscal rule (4 debates)	30-Sep				
Tax competitiveness (4 debates)	15-Oct	24-Nov			
Formalization and first job (4 debates)	19-Aug	30-Nov			

Source: Ministry of Finance, Barclays Capital

Figure 6: Successful inflation targeting



Source: DANE, Banrep, Barclays Capital

Figure 7: Colombia macroeconomic forecasts

	2007	2008	2009	2010P	2011F	2012F
Activity						
Real GDP (% y/y)	6.9	2.7	0.8	4.2	4.3	4.1
Domestic Demand Contribution (pp)	8.9	3.5	1.8	4.1	5.6	5.1
Private Consumption (% y/y)	7.3	3.0	1.1	3.3	4.6	4.4
Gross Fixed Capital Formation (% y/y)	14.4	4.9	2.7	4.2	8.9	7.4
Net Exports Contribution (pp)	-1.8	-0.9	1.4	-2.6	-0.9	-0.9
Exports (% y/y)	6.9	6.1	-2.8	0.6	3.7	2.2
Imports (% y/y)	14.0	8.8	-7.9	12.2	6.5	5.3
GDP (USD bn)	208	243	253	291	312	348
External Sector						
Current Account (USD bn)	-6.0	-6.9	-5.0	-7.1	-8.0	-7.4
CA (% GDP)	-2.9	-2.8	-2.0	-2.4	-2.6	-2.1
Trade Balance (USD bn)	-0.6	1.0	2.5	2.1	2.3	4.5
Net FDI (USD bn)	8.1	8.3	4.1	6.5	8.0	9.0
Other Net Inflows (USD bn)	2.2	1.1	2.2	3.6	2.8	-1.6
Gross External Debt (USD bn)	44.6	46.4	53.7	63.0	69.3	76.2
International Reserves (USD bn)	21.0	24.0	25.4	28.4	31.2	31.2
Public Sector						
Non-financial Public Sector Balance (% GDP)	-0.6	-0.1	-2.7	-3.6	-3.2	-0.9
Central government balance (% GDP)	-2.7	-2.3	-4.1	-4.3	-4.1	-2.9
Central primary balance (% GDP)	1.0	0.9	-1.1	-1.3	-1.0	0.2
Gross Non-financial Public Sector Debt (% GDP)	32.4	31.9	34.9	37.5	38.6	37.0
Net Non-financial Public Sector Debt (% GDP)	22.4	24.9	26.9	29.0	29.8	28.2
Net central government debt (%GDP)	36.6	36.4	38.1	38.8	39.9	39.3
Prices						
CPI (% Dec/Dec)	5.7	7.7	2.0	2.7	3.3	3.0
CPI (% average)	5.5	7.0	4.2	2.2	3.2	3.2
Exchange Rate (dom currency/USD, eop)	2018	2249	2029	1950	1850	1832
Exchange Rate (period average)	2075	1970	1988	1875	1900	1841
	1y ago	**Last**	**4Q10F**	**1Q11F**	**2Q11F**	**3Q11F**
Real GDP (y/y)	3.0	4.5	3.9	4.2	4.4	4.4
CPI (% y/y, eop)	2.0	2.3	2.7	3.0	3.3	3.4
Exchange Rate (dom currency/USD, eop)	2029	1922	1950	1920	1850	1850
Monetary Policy Benchmark Rate (%, eop)	3.50	3.00	3.00	3.00	3.00	3.25

Source: Haver Analytics, Barclays Capital

LATAM: MEXICO

The elusive quest for growth

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We expect 2011 to be weaker than 2010 in terms of GDP growth but just as smooth in terms of the absence of disruptive idiosyncratic developments. With low growth and no rate cuts, we remain unexcited about the MXN, but its safe-haven status will help.

Strategy: We are moderately constructive on the MXN and believe the recent sell-off has created value in nominal rates. We recommend adding to long-end receivers.

Moderation and rotation

The economy is returning to trend growth after a cyclical bounce

Since the publication of "*Mexico: Slipping back into old patterns*" in the previous edition of The Emerging Markets Quarterly, September 21, 2010, incoming data have continued to show signs of moderation. As we argued in that report, the cyclical impulse underpinning the strong recovery observed in 2010 seems to have largely run its course; and the economy is transiting to a pace of expansion more aligned with its long-term trend (Figure 1).

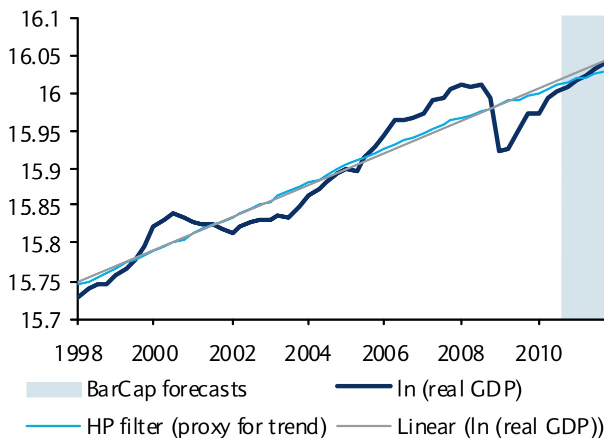
Trend growth, unfortunately, is lower than that of its peers…

Unfortunately, this now means the authorities face a more fundamental problem than pulling the economy out of a crisis. Indeed, trend growth has slowed meaningfully over the past decade, falling behind that of Brazil and other Latin American economies, and the blistering-growth of economies such as China (Figure 2.)

…for reasons that are ongoing subject of debate

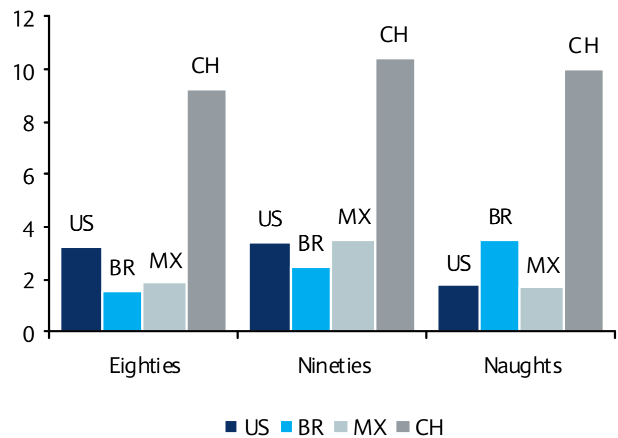
The reasons for this underperformance are unclear and are the subject of ongoing debate. Different analysts and commentators at the government, multilateral organizations, and academia, have pointed to various culprits. In its periodical reports, for example, Banxico has stressed the need to undertake reforms to enhance competition and improve the provision of public (or semi-public) goods such as energy, transportation and public infrastructure. Meanwhile, this year's IDB flagship report emphasised the need to boost productivity, and identified the small size of firms as a key factor preventing productivity growth. Finally, the WEF 2009 competitiveness report, applying a "growth diagnostics" methodology concludes that there is no obvious "binding constraint" to growth in Mexico and recommends that the authorities identify sector-by-sector constraints to growth.

Figure 1: Shifting focus from the cycle to the trend



Source: Haver Analytics, Barclays Capital

Figure 2: A poor record in the 2000s



Source: Haver Analytics, Barclays Capital

China's ascent seems to have damaged the economy's competitiveness…

While not dismissing the merit of any of these views, we have highlighted the ascent of China in the global economy as a seemingly critical factor hurting Mexico's performance in the past decade. As a manufacturing exporter, Mexico's economic complementarity with China seems small, while the competition from it is overwhelming. As such, unlike its commodity-exporter peers in the region, Mexico did not enjoy as dramatic a rise in its terms of trade, and could not as easily afford an expansion in its real domestic demand.

…and it is unclear whether this can change in the near future

Whether this situation might improve in the coming decade is at the core of investors' medium-term questions on Mexico. Several hopes have been placed on China's wage inflation, yuan appreciation, and higher transportation costs. However, although such factors could entail some relief for the Mexican economic outlook, the occasional optimistic narrative tends to overlook productivity considerations – without which wage comparisons are incomplete.

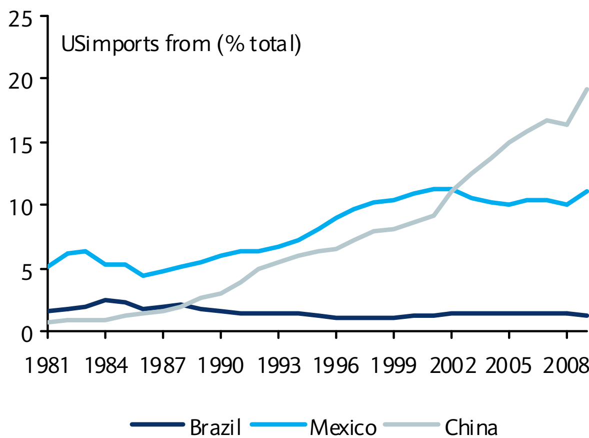
We, thus, expect a moderation of GDP growth to 3.2% next year…

In our view, even if there was some relief from China's competition, we would expect it to be slow and thus, unlikely to change the outlook for the coming quarters – the typically relevant time frame for financial investments. Against this backdrop, we continue to expect a moderation in real GDP growth in 2011 to 3.2% (from 5.1% in 2010), with the pace of expansion stabilizing thereafter at about 3%. If anything, this level seems optimistic *vis a vis* Mexico's growth performance in the 2000s.

…albeit with a greater contribution from domestic demand

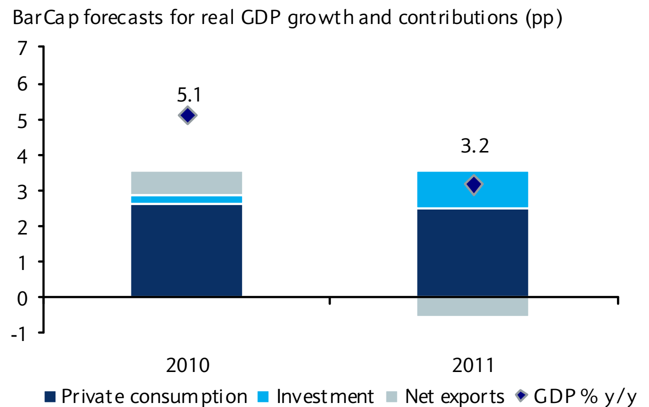
The good news, from a domestic spending standpoint, is that even as overall GDP growth drops, it is unlikely to be as outwardly oriented as it has been in 2010. We expect private consumption growth to remain roughly unchanged at 3.6% in 2011, despite a less favourable base, and gross fixed capital formation to finally bounce a firmer 5.0% after a very sluggish year. Overall, we think the contribution of these components to GDP growth will likely increase in absolute terms next year; even if overall growth will most probably be lower (Figure 4).

Figure 3: Displaced by China?



Source: Haver Analytics, Barclays Capital

Figure 4: Growth rotation



Source: Haver Analytics, Barclays Capital

Monetary and FX policy

Limited role for macroeconomic policy to come to the rescue…

As Mexico's modest growth outlook seems to increasingly reflect structural challenges rather than a cyclical condition, we believe macroeconomic policy is not the right tool to revitalize the economy at this juncture. Our expectation for the composition of growth to rotate toward domestic demand also supports this view, as does the recovery of capacity utilization to close to 80% - not an all-time peak but roughly the pre-crisis level.

…although lingering slack in the labor market is likely to discourage thoughts of rates normalization

One indicator that lends itself to more doubts is unemployment. Even though formal employment has recovered materially in tandem with GDP, the seasonally-adjusted unemployment rate has dropped only 50bp since its 6% peak. This stickiness resonates with the situation in the US labor market. However, we note that: 1) the joblessness rate never jumped as much in Mexico as in the US; and 2) the Mexican labor market seems to have suffered less than in previous recessions (while in the US, the labor market suffered more than in previous recessions). In any case, we think the state of the labor market might reassure Banxico that it is not facing an urgent overheating threat, even if other output gap metrics point to caution.

Inflation will take a dip in Q1, but only a temporary one

Meanwhile, on the inflation front, we think the underlying sequential core inflation trend has bottomed out on the back of the output gap narrowing. Even if we expect the headline and core y/y rate to take a dip at the onset of 2011 (reflecting favourable base effects from the VAT tax and some public price increases) we think it will resume an upward trend thereafter. Although Banxico has hinted to the market that it intends to make use of the tolerance range around its 3% target (and, therefore, we no longer expect it to start normalization in 2011 on the back of a slight inflation pickup), we do not think it will ease monetary conditions further either.

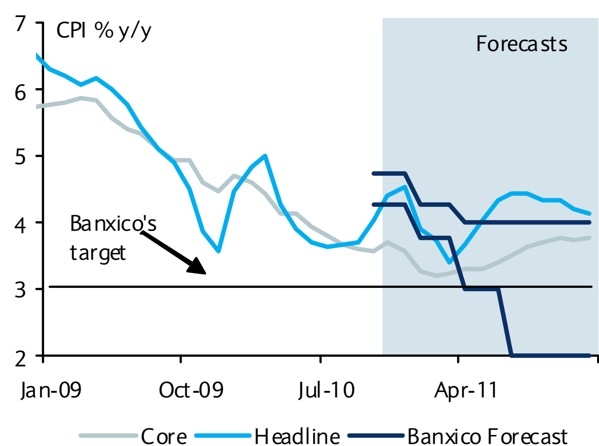
The risks around our inflation and rates call are balanced, in our view

We view the risks around these calls as fairly low and balanced. On the one hand, further increases in commodity prices such as those observed in recent months could produce a non-negligible pickup in inflation and, potentially, elicit an earlier-than-expected normalization of the policy rate (see *Easy money is not easy for all EM,* November 23 2010). On the other hand, if international financial conditions improve, and the MXN rallies to concerning levels, Banxico could be tempted to deliver a rate cut to discourage inflows. That said, we think that even in this scenario Banxico would most likely resist the temptation and avoid signalling that currency considerations are taking precedence over its inflation mandate. We pencil in some adjustment in the policy rate starting in January 2012, going to 5.5% from the current 4.5%, but do not expect Banxico to take the policy rate to a more neutral level of 6.5% until 2013.

Figure 5: More formal jobs but sticky overall joblessness

Source: Haver Analytics, Barclays Capital

Figure 6: Inflation forecasts



Source: Banxico, Barclays Capital

Fundamental support for the peso remains scarce, but its status as "safe haven" should help

Our growth and rates outlook remain unsupportive of a strong currency performance. However, since the launching of QE2 in the US and the spread of ad hoc intervention measures throughout the EM world, the medium-term underperformance trend we had identified for the MXN reversed. We think the currency benefited from safe-haven status in the context of widespread ad-hoc measures in other currency investments with greater fundamental appeal. Although we believe the substitution triggered by intervention elsewhere has largely run its course and do not expect outperformance to be as significant as in recent months, we have become moderately constructive on account of the friendlier policy backdrop relative to other EMFX, despite a weaker macro backdrop.

Ad hoc risks?

We do not envision idiosyncratic market disruptions…

Although we think 2011 is likely to be a less exciting year in terms of growth, we believe it will be just as smooth as 2010 in terms of the relatively limited number of idiosyncratic factors disrupting market performance.

…neither from the fiscal front…

In our view the government's fiscal plans for 2011 are not zealous in terms of restoring fiscal accounts to their relative soundness before the crisis, or addressing Mexico's long-term fiscal challenges. We also do not think this aim will be pursued in 2012 (a presidential election year), even if the government sticks to its pledge of balancing the budget ex-PEMEX investment (because this pledge entails a looser commitment than what the pre-crisis fiscal rule would have implied, Figure 7.) However, we envision very limited execution or financing risks next year and, moreover, the sovereign's public debt at 36% of GDP (in its broadest definition) speaks for, in the current global context, an enviable fiscal situation.

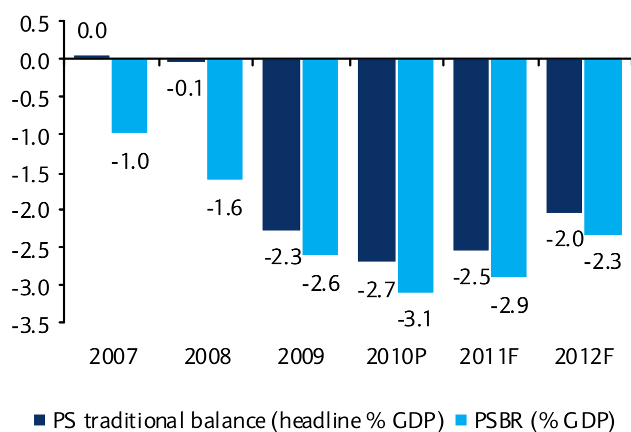
…nor from the external side.

On the external accounts front, we expect a worsening of the trade and current account balances to 1.2% of GDP in 2011, following a very small deficit projected for 2010 (0.4%). We view this development as consistent with the rotation in the composition of GDP growth underway and far from worrisome at this level. Its financing is also reassuring, with roughly 70% projected to be covered with fairly diversified (geographically and sector-wise) net FDI inflows.

The 2012 presidential elections will not catch investor focus for a while…

Finally, political risk also seems limited, as investors are unlikely to focus much on politics until a few months before the presidential elections in July 2012. However, a number of subnational elections next year could prove to be market relevant, and, based on this year's Tamaulipas incident, they could be accompanied by heightened violence. (Figure 8)

Figure 7: No return to pre-crisis balances



Source: SHCP, Barclays Capital

Figure 8: Election calendar

Date	State	Election type
Jan 30	Guerrero	Governor
Feb 06	Baja California Sur	Governor + deputies + mayors
Jul 03	Coahuila	Governor + deputies
Jul 03	Hidalgo	Mayors
Jul 03	Estado de México	Governor
Jul 03	Nayarit	Governor + deputies + mayors
Nov 13	Michoacán	Governor + deputies + mayors

Source: IFE, Barclays Capital

…but they may condition progress on the policy front

Regarding the policy outlook, we doubt much progress can be made before 2012, as political parties will probably turn the bulk of their attention to the presidential campaign sooner rather than later in 2011. Following valuable (albeit not totally successful) efforts by the Calderon administration to tackle difficult reforms, we think the authorities will stick to smaller fixes and improvements in ad hoc areas (eg, Cetesdirecto) which, while not adversely affecting investors' perception of Mexico, are unlikely to revitalize it. The quest for growth, elusive as it has been, might not regain momentum until 2012.

Figure 9: Mexico macroeconomic forecasts

	2007	2008	2009	2010P	2011F	2012F
Activity						
Real GDP (% y/y)	3.3	1.5	-6.1	5.1	3.2	3.0
Private Consumption (% y/y)	4.0	1.9	-6.1	3.7	3.6	3.3
Fixed Capital Investment (% y/y)	6.9	4.4	-10.1	1.4	5.0	4.8
Net Exports Contribution (pp)	-0.6	-0.8	1.7	0.6	-0.6	-0.6
Exports (% y/y)	5.7	0.5	-14.8	24.6	6.7	5.8
Imports (% y/y)	7.1	2.8	-18.2	20.7	8.1	7.1
GDP (USD bn)	1036	1093	884	1035	1130	1224
GDP (MXN bn)	11321	12200	11930	13094	14071	15083
External Sector						
Current Account (USD bn)	-8.7	-16.5	-6.2	-4.4	-13.5	-18.2
CA (% GDP)	-0.8	-1.5	-0.7	-0.4	-1.2	-1.5
Trade Balance (USD bn)	-10.1	-17.3	-4.6	-4.6	-13.0	-17.6
Net FDI (USD bn)	20.8	23.8	6.9	7.0	9.0	10.5
Other Net Inflows (USD bn)	0.6	2.5	10.7	23.5	22.5	22.5
Gross External Debt (USD bn)	193	201	192	221	246	267
International Reserves (USD bn)	78	85	91	112	130	145
Public Sector						
PS traditional balance (headline % GDP)	0.0	-0.1	-2.3	-2.7	-2.5	-2.0
PS primary balance (% GDP)	2.2	1.8	-0.1	-0.6	-0.3	0.2
PSBR (% GDP)	-1.0	-1.6	-2.6	-3.1	-2.9	-2.3
Gross Public Debt (% GDP)	22.6	26.8	34.8	34.1	33.9	33.8
Net Public Debt (% GDP)	17.5	21.3	31.1	30.5	30.3	30.3
Historical Balance of PSBR (% GDP)	29.9	35.7	36.7	36.0	35.8	35.7
Prices						
CPI (% Dec/Dec)	3.8	6.5	3.6	4.5	4.1	3.7
CPI (% average)	4.0	5.1	5.3	4.2	4.1	3.8
Exchange Rate (dom currency/USD, eop)	10.90	13.67	13.09	12.70	12.20	12.44
Exchange Rate (period average)	10.93	11.16	13.50	12.65	12.45	12.32
	1yr Ago	**Last**	**Q410F**	**Q111F**	**Q211F**	**Q311F**
Real GDP (y/y)	-2.0	5.3	3.2	4.7	2.9	2.9
CPI (% y/y, eop)	3.6	4.0	4.5	3.4	4.3	4.3
Exchange Rate (dom currency/USD, eop)	13.09	12.51	12.70	12.40	12.20	12.20
Monetary Policy Benchmark Rate (%, eop)	4.50	4.50	4.50	4.50	4.50	4.50

Source: Haver Analytics, SHCP, Barclays Capital

LATAM: PERU

The risks of success

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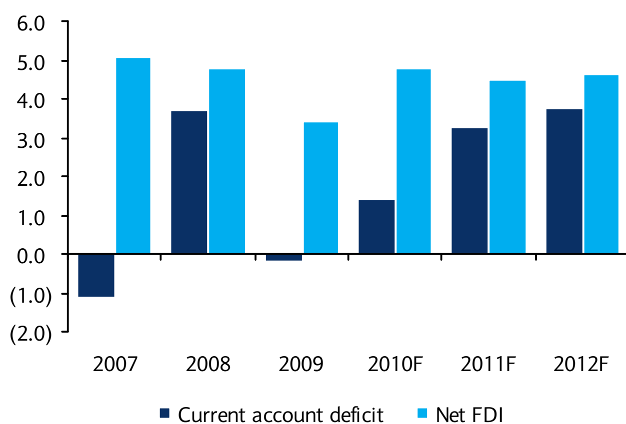
Peru's economy has outperformed those of the rest of Latin America. In 2010, Peru has registered the region's highest rate of growth – a lead we expect it to maintain for the next two years. Our short-term concerns lie mainly in Peru's ability to avoid a greater widening of the current account deficit and burgeoning inflationary pressures. And although political risks look lower, the electoral landscape remains unclear. Given relatively cheap valuation, and lower political risk, we have decided to change our recommendation from Underweight to Market Weight.

Challenges ahead

We expect Peru's economy to grow by 8.9% in 2010 – nearly 3pp more than the average growth we project for Latin America's seven biggest economies. Even with some moderation in growth, Peru should continue to perform strongly for the next two years. We forecast growth of 7.7% in 2011 and 6.8% in 2012, driven by investment and private consumption. With this strong outlook and commodity prices set to remain high, risk lies in the difficulty of averting potential threats. Containing current-account deterioration as high domestic demand growth fuels a rise in imports is one such challenge. In addition, higher international food prices mean caution will be needed to minimize domestic inflationary pressures.

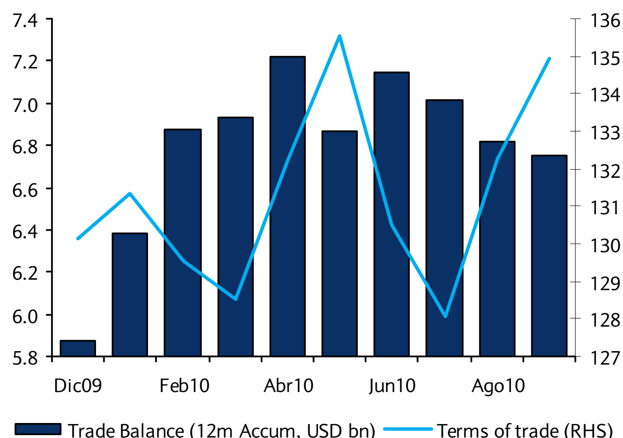
Strong domestic demand growth has re-accelerated imports, which we expect to rise by 36.3% (28.6% in real terms) in 2010, mainly on demand for inputs and capital goods for investment projects. Considering the growth outlook, imports should continue to grow strongly for the next two years, even if there is some moderation in the years ahead. Meanwhile, exports have been rising much more modestly, and mainly on higher mineral prices; in real terms, we forecast export growth in 2010 at just 2.7%, with the volume of gold and copper exports registering, respectively, a contraction of 8.9% and a rise of just 2.7%. This has spurred a widening of the current account deficit, which we expect to reach 1.4% of GDP in 2010 (from a surplus of 0.2% of GDP in 2009). However, considering that some investment projects in the mining sector are not scheduled to mature in the short term, and that gold and copper price look set to rise more moderately over the next two years, we forecast the current account deficit to reach 3.3% of GDP in 2011 and 3.8% in 2012.

Figure 1: CAD covered by FDI (% GDP)



Source: BCRP, Barclays Capital

Figure 2: Trade balance deterioration despite improving TOT



Source: BCRP, Barclays Capital

Risk associated with this deterioration of the current account is mitigated by a strong position in international reserves and the flow of foreign direct invest (FDI), which we expect to reach a record high in 2010 of USD 7.4 bn (5.3% of GDP) and which should remain strong as returns from investment are reinvested. However, net foreign capital flows will likely diminish given that short-term capital inflows and external borrowing, discouraged by the authorities, look set to fall. Thus, the possibility of a persistent erosion of the cushion provided by FDI has the potential to become a source of concern. Considering the fast dynamic of growth in the private sector, the clearest way, in our view, to contain a further deterioration of the current account would be countercyclical public sector action to retire the fiscal stimulus put in place in the past two years. The policy path on this front will depend in part on the results of the presidential election. For now, we expect the 2011 budget to show some expenditure moderation, but to register an increase in real terms.

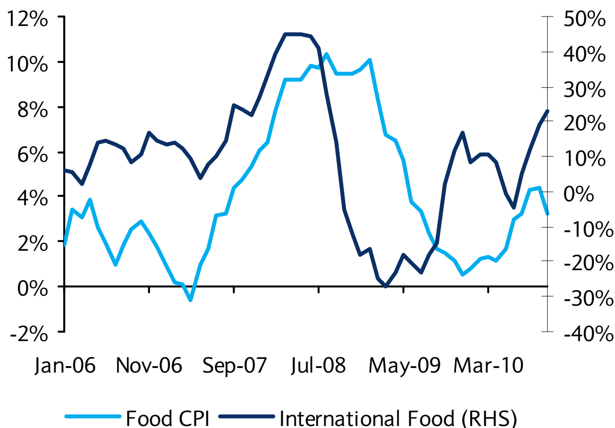
Another source of concern is the potential impact of the rise of international food and fuel prices on domestic inflation. So far, inflation seems to be under control: high growth appears to have put upward pressure on local prices, but the rise in international prices does not yet seem to have filtered through to domestic prices. However, considering that imports of food are relatively low, the pass-through of international price movements has lagged in the past. Therefore, with food representing 37.8% and energy 5.7% of the consumption basket, government action may be necessary to avoid a deviation from the 2.0% target. We maintain our view of a progressive normalization of interest rates in 2011, to 4.0% in Q4 11, starting in March with a 25bp hike.

Political risks neutralized

The probability of victory by an anti-market candidate in next year's presidential race has diminished

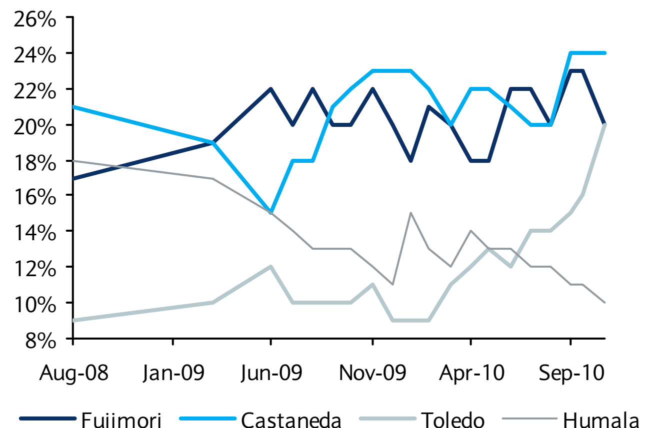
The three main candidates in next year's presidential election, none of whom is expected to make any significant changes to economic policy, are currently roughly even in the opinion polls (eg, Ipsos-Apoyo). The most important change in recent months has been the rise of Alejandro Toledo (Peru Posible), who has reached 20% support in the polls, drawing equal with Keiko Fujimori (Fuerza 2011) and increasing the probability that he will go to a second round. Meanwhile, Luis Castañeda (Solidaridad Nacional) maintains a narrow lead, with 24%, and has made notable strides in boosting his support in Peru's interior. That said, the announcement of the candidature of former finance minister Mercedes Araoz, as the presidential candidate for the incumbent APRA party has eroded his support in the north.

Figure 3: Domestic and international food inflation



Source: BCRP, Haver, Barclays Capital

Figure 4: Electoral landscape remains unclear



Source: Ipsos-Apoyo, Barclays Capital

Meanwhile, possible political noise related to support for a radical political proposal to reverse the economic reforms of the past two decades seems to have been neutralized. Although recent polls have focused mainly on urban areas, left-leaning candidate Ollanta Humala has not registered a significant increase in popularity, with Keiko Fujimori dominating the race among the poorest sectors of the population. With this less risky political scenario and relatively positive valuation we have decided to change our recommendation on Peru from Underweight to Market Weight.

Figure 5: Peru: Macroeconomic forecast

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	9.0	9.8	0.9	8.9	7.7	6.8
Private Consumption (% y/y)	8.3	8.7	2.4	6.0	6.1	5.9
Private Fixed Capital Investment (% y/y)	23.4	25.8	-15.2	22.8	19.4	12.7
Exports (% y/y)	6.2	8.8	-2.5	2.7	5.4	5.5
Imports (% y/y)	21.3	19.8	-18.4	28.6	18.7	11.5
GDP (USD bn)	107.3	127.4	126.8	139.5	156.8	177.2
External Sector						
Current Account (USD bn)	1.2	-4.7	0.3	-2.2	-5.7	-7.9
CA (% GDP)	1.1	-3.7	0.2	-1.4	-3.3	-3.8
Trade Balance (USD bn)	8.3	3.1	5.9	7.1	5.4	5.5
Net FDI (USD bn)	5.4	6.1	4.4	7.4	7.8	9.0
Gross External Debt (USD bn)	32.6	35.1	34.9	35.7	36.3	36.8
International Reserves (USD bn)	27.7	31.2	33.2	46.2	49.3	51.9
Public Sector						
Public Sector Balance (% GDP)	3.1	2.2	-2.1	-0.8	-0.2	0.8
Primary Balance (% GDP)	4.8	3.7	-0.9	0.3	1.1	2.0
Gross Public Debt (% GDP)	29.7	23.6	26.7	22.4	20.6	18.6
Prices						
CPI (% Dec/Dec)	3.9	6.7	0.3	2.3	2.5	2.3
FX (PEN per USD, eop)	3.00	3.14	2.88	2.85	2.75	2.67
	1yr Ago	**Last**	**10Q4F**	**11Q1F**	**11Q2F**	**11Q3F**
Real GDP (y/y)	-0.6	9.6	8.9	8.7	7.8	7.4
CPI (% y/y, eop)	1.2	2.4	2.4	2.4	2.2	2.5
Exchange Rate (PEN per USD, eop)	2.88	2.78	2.85	2.83	2.78	2.75
Monetary Policy Benchmark Rate (%, eop)	1.25	3.00	3.00	3.25	3.50	3.75

Source: BCRP, Ministry of Finance, INEI, Barclays Capital

LATAM: URUGUAY

Another conflicted central bank

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We expect Uruguay to grow 8.4% in 2010 but slow to 4.6% in 2011. However, in the short term, inflation is expected to be above the central bank's target range. Concerns over the strength of the currency and the expected slowdown of activity are likely to drive the central bank to a very gradual hiking path.

In a scenario in which US rates are expected to stay low, the dollar remains weak and with strong commodity prices, the country's growth outlook remains promising into 2011. In addition, Argentina and Brazil are expected to remain supportive of Uruguay's growth, as those economies are forecasted to grow 5.3% and 4.5%, respectively (Figure 1).

Uruguay is expected to grow 8.4% in 2010 and 4.6% in 2011

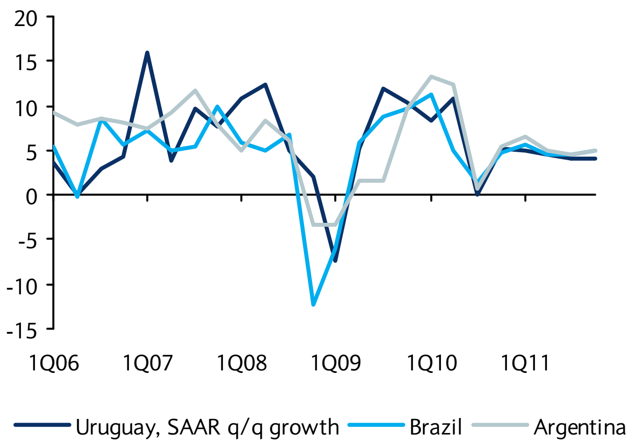
While we expect GDP growth to have moderated to 0% saar in Q3, we expect a rather good Q4 10 (5.3% saar). This performance should allow the country to enjoy a strong 2010 GDP growth rate, which we are tracking at about 8.4%. For 2011, we forecast it to slow to 4.6%.

Inflation expectations have stabilized

In this environment, with very limited idle capacity, inflation is likely to remain a challenge for the authorities (Figure 2). However, 12-month inflation expectations seem to have stabilized, edging lower in November to 6.8%. This might well be related to the surprising September interest rate hike of 25pp (to 6.5%).

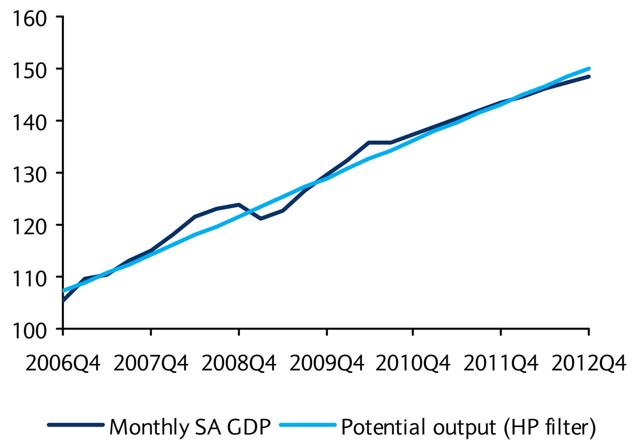
Interestingly, 1y breakevens caught up with consensus inflation expectations during October (Figure 3). While it is not always easy to understand bond price moves, we think that market behavior had mostly to do with a sequence of inflation surprises. The sudden climb of breakeven inflation matches the pickup in the October inflation reading (0.64 m/m, 7.0% y/y), which put inflation above the central bank's targeted range (4-6). The short end of the inflation linkers curve has rallied 1.1pp, to historic lows (the 1y is currently 1.4%), since mid-October, while nominal rates compressed only a slight 0.03pp, to 8.6%.

Figure 1: Argentina and Brazil support Uruguay's growth



Source: Barclays Capital

Figure 2: Growth moderation should contain inflation



Source: Barclays Capital

While we do not expect food prices to increase sharply in 2011, this will be a risk

We expect growth moderation in 2011, as output gradually converges to potential. We also expect slower demand growth, coupled with a slightly tighter monetary policy, to imply less price pressure in the quarters to come (Figure 2). In addition, FX nominal appreciation pressures are expected to continue, which should also assist the central bank in containing inflation. While we do see some upside risks to inflation, due mostly to food inflation, food prices have declined from recent highs. Furthermore, the Barclays Capital Commodities team foresees only a modest increase in them, which should provide some relief to future inflation readings. That said, our baseline scenario includes a "hump" in inflation that should fade going into Q2 11, driving inflation to converge back inside the target band.

More fiscal effort is needed

Last but not least, economic policy in Uruguay seems to be gearing up to leverage this benign global environment. The authorities seem committed to reducing the vulnerability that arises mainly from dollarization and relatively high debt levels (gross debt stands at 63.8% of GDP). Their strategy seems focused on a reduction of debt/GDP levels, a shrinkage of the share of USD denominated debt, and the accumulation of international reserves through FX intervention with the aim of assuring a competitive FX to the "productive" sector. Their degree of success will determine whether Uruguay's credit ratings climb. However, the government's strategy seems somewhat complacent on the fiscal side. Policymaking should require improvements in the debt ratio to depend less on dollar GDP reflation and on an FX strategy that results in less money printing. This, of course, requires more fiscal effort than what the government has delivered (Figure 4).

We expect the peso to stay mostly flat in the remainder of 2010 and Q1 11

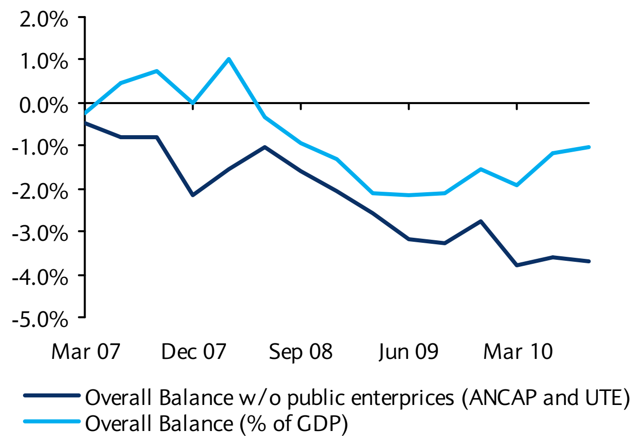
External flows continue to be important drivers of the UYU. We expect the currency to remain well bid in the quarters to come and to end 2010 at 19.9 and to remain flat at least throughout Q1 11. Going further into 2011, we believe the action in the BRL will govern the appreciation pressures that the central bank has to face.

The central bank has a difficult job ahead. On the one hand is the need to contain the FX rate, an explicit government objective; on the other is the need to contain an inflation rate that stands above the target range. As a result, the central bank is likely to move gradually starting in Q1 while waiting to see if the inflation hump effectively fades away.

Figure 3: Inflation breakevens have caught up with expectations

Source: Barclays Capital

Figure 4: Genuine fiscal effort has not been that rigorous



Source: Barclays Capital

Figure 5: Macroeconomic forecasts

	2007	2008F	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y), RHS	7.2	8.7	2.4	8.4	4.6	3.8
Domestic Demand Contribution (pp)	6.8	12.2	-1.3	10.2	6.1	4.5
Private Consumption (% y/y)	7.0	8.5	1.0	9.9	6.1	4.6
Fixed Capital Investment (% y/y)	7.9	19.0	-4.4	11.5	6.3	4.1
Net Exports Contribution (pp)	0.4	-3.5	3.7	-1.7	-1.4	-0.7
Exports (% y/y)	7.4	10.1	2.5	8.0	2.5	2.5
Imports (% y/y)	5.7	21.0	-8.6	13.5	6.8	4.4
GDP (USD bn)	24.0	31.2	31.5	40.2	43.2	48.8
External Sector						
Current Account (USD bn)	-0.2	-1.5	0.3	0.5	-0.2	-0.3
CA (% GDP)	-0.9	-4.8	0.8	1.3	-0.5	-0.5
Trade Balance (USD bn) (FOB)	-0.5	-1.7	-0.3	0.2	-0.6	-0.8
Net FDI (USD bn)	1.2	1.8	1.3	1.5	1.7	1.7
Other Net Inflows (USD bn)	1.3	3.7	1.4	-0.4	0.6	1.0
Gross External Debt (USD bn)	12.2	12.0	12.9	13.8	14.7	15.6
International Reserves (USD bn)	4.1	6.3	8.0	8.1	8.5	9.2
Public Sector						
Public Sector Balance (% GDP)	0.0	-1.5	-1.7	-1.1	-1.1	-1.2
Primary Balance (% GDP)	3.4	1.4	1.1	1.7	1.7	1.7
Gross Public Debt (% GDP)	68.0	53.1	69.5	63.8	59.4	52.6
Net Public Debt (% GDP)	40.2	26.5	35.4	33.4	33.0	32.5
Prices						
CPI (% average)	8.1	7.9	7.1	6.7	6.6	5.9
FX (UYU per USD, eop)	21.5	24.4	19.5	19.9	19.9	20.5
Exchange Rate (period average)	23.3	21.0	22.4	19.7	19.9	20.2
	1yr Ago	**Last**	**Q410F**	**Q1 11F**	**Q2 11F**	**Q3 11F**
Real GDP (% y/y)	2.3	8.0	6.8	5.9	3.6	4.7
CPI (% y/y, eop) *	7.5	6.7	6.7	6.8	6.7	6.7
Exchange rate (ARS/USD, eop)	20.14	19.85	19.90	19.90	19.90	19.80
Monetary policy rate	8.00	6.50	6.50	6.75	7.00	7.00

Source: Ministry of Finance and Central Bank of Uruguay, Barclays Capital

LATAM: VENEZUELA

Time to build positions

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We advise investors to increase exposure to Venezuela. Three arguments support this view. First, we expect an official devaluation of the exchange rate, while some tax increases are being considered by the government. Second, despite a debt increase, the capacity to pay is not an issue. Third, authorities could intervene and buy back some of the bonds.

Moderate economic recovery

Economic activity data for Q3 show that real GDP fell 0.4% y/y, driven by a 17.6% y/y drop in exports – the largest decline since 2003, just after the oil strike. These results reflect the effects of the reduction in oil production agreed upon by OPEC members at the end of 2009, as well as some problems with refineries. We expect economic activity to turn positive in Q4, and for 2011, we expect 2.1% growth based on a "rebound effect," an improvement in power rationing, and a moderate increase in public sector investment. However, the low level of private investment will limit the ability of the non-oil sectors of the economy to respond to fiscal stimulus if the authorities implement, as expected, an expansionary fiscal policy focused on the 2012 presidential election. For the next two years, the increase in aggregate demand is likely to lead to a rise in import demand and the persistence of inflationary pressures. We expect an inflation rate of 24.8% in 2011.

We expect an official devaluation of the exchange rate

Given the importance of the exchange rate to the fiscal and debt figures, the fact that the country has four different exchange rates causes important distortions of the results of some of the principal economic indicators, and the trends that we build from them will be highly dependent on our FX assumptions. Therefore, we consider it important to revise our estimates.

In *Venezuela: Devaluation could come in the new year*, November 18, 2010, we calculated the weighted average exchange rate for the Venezuelan economy, highlighting that the largest devaluation that Venezuelans suffered from this exchange rate control was in 2009, when the authorities did not move the official FX rate. We also highlighted that we expect a devaluation of the exchange rate of at least 15%; this means that if the government conducts a linear devaluation, the new exchange rates would be VEB3.0/USD and VEB5.0/USD for CADIVI and VEB6.5/USD for SITME. Although our base case scenario is a 15% linear devaluation, we do not discount the possibility of a higher nominal devaluation and/or a disguised devaluation. Figure 1 shows our principal findings.

We expect a reduction in the inflation rate to 24.8%.

Using this average exchange rate, we recalculate the USD GDP, fiscal, and debt figures. We wrote in *Venezuela: Taking a breather*, January 26, 2010, that we did not expect a significant increase in the inflation rate because most of the devaluation happened in 2009. As we can see from Figure 1, without an official announcement, the government devalued the average exchange rate by 44.5%, from VEB2.58/USD in 2008 to VEB3.68/USD in 2009, by reducing the proportion of dollars that it sold at the stronger exchange rate (at that moment, the official rate was VEB2.15/USD) from 60% to 39% and increasing the proportion of dollars that it sold at the weaker rates through government issuance and the parallel market. For 2011, we expect an average weighted devaluation of 22.6%, with a new reduction in the inflation rate.

Figure 1: We expect a devaluation of 22.6% in 2011

	2009		2010 F		2011 F		2012 F	
	Weight	VEB/$	Weight	VEB/$	Weight	VEB/$	Weight	VEB/$
CADIVI 1	39%	2.15	18%	2.60	14%	3.0	9%	3.0
CADIVI 2			27%	4.30	31%	5.0	36%	5.0
Public enterprises	19%	2.15	26%	2.60	23%	3.0	22%	3.0
New issuance	10%	4.95	7%	5.64	7%	6.5	7%	8.0
SITME			6%	5.30	12%	6.5	11%	8.0
Parallel/black market	32%	6.03	15%	7.61	14%	9.5	15%	11.9
Weighted average		**3.68**		**4.20**		**5.15**		**5.97**
Devaluation		44.5%		14.4%		22.6%		15.9%

Source: Barclays Capital

We expect an improvement in the public sector balance

Given that the country has been in a deep recession, it seems odd that public expenditures have not increased significantly despite higher oil prices, the positive effect of currency devaluation at the beginning of 2010, and the elections in September. In fact, cumulative central government expenditures until October declined 12% y/y in real terms, compared with the same period in 2009. These figures imply that a more conservative fiscal policy is being implemented by Finance Minister Jorge Giordani.

The cabinet has discussed an increase in the VAT rate and a new tax on the domestic price of gasoline

In addition, the economic cabinet has reportedly discussed the possibility of an increase in the value added tax rate from 12% to 15% and a new tax on the domestic price of gasoline, which would essentially have the same effect as a price increase by PDVSA. In our opinion, this adjustment in fiscal figures is consistent with a strategy of saving resources for the biggest battle: the presidential election in 2012. Given past electoral results, President Chavez will likely make most of the fiscal adjustments in Q1 11, looking to dilute their political cost and seek better economic conditions for 2012. Nonetheless, we also highlight the difficulty of calculating fiscal figures, since the barriers among PDVSA, the central government, the central bank, the development bank, and the public financial system are practically nonexistent, with increased transfers among all the public institutions.

We expect an improvement in fiscal figures, closing with deficits of 1.3% and 1.2% for 2010 and 2011, respectively

Still, just taking into account the devaluation of the currency, we expect an improvement in the public sector balance despite the contraction in the economy. We estimate that total income for the restricted public sector will reach 31.9% of GDP, given an average price for the Venezuelan oil basket of USD71/bbl in 2010. Considering that total expenditures amount to 33.2% of GDP, this should result in a deficit of 1.3% of GDP. Similarly, for 2011, we expect public sector income to increase to 32.5% of GDP, assuming an average price of the Venezuelan oil basket of USD76.5/bbl, which could give the government room to increase expenditures to 33.7% of GDP, resulting in a deficit of 1.2% of GDP.

A worrisome increase in debt, but with strong capacity to pay

The increase in total public debt is worrisome

Using the average weighted exchange rate, we calculate external and internal debt, both in USD and as a percentage of GDP (Figure 3). Total public debt in Venezuela (internal and external, including the republic, PDVSA, and the Chinese fund), is expected to increase 85%, from USD60.5bn in 2008 to an USD112.0bn in 2011. This includes USD3.0bn of the expected private placement made by PDVSA to the BCV in mid-December and USD10bn of new issuance for next year (mostly in the second half), of which we expect approximately USD4bn from the republic and USD6bn from PDVSA. In addition, as a share of the GDP, the

total public debt is more worrisome, increasing from 23.0% of GDP in 2008 to an expected 53.7% of GDP in 2011. Looking at these figures, we are concerned about the level of total public debt and not just its trend.

But the cost to pay is extremely low, and the capacity to pay is guaranteed

Nonetheless, one of the benefits of capital control is that it allows the republic to issue debt at relatively low rates. For example, thanks to a differential of almost 300% between the official exchange rate and the parallel market rate at the end of July 2009, PDVSA was able to issue a zero-coupon debt with a premium of 92%. In addition, through continued issuance, the Venezuelan amortization schedule is well balanced over the next 30 years, with low concentrations in the short run. Moreover, using its exchange rate control, Venezuela has introduced an excess of VEB to the financial system, pressuring the real interest rate into negative territory, amplifying the maturities, and making internal debt service inexpensive. Putting all this together, we calculate the implicit cost of total public debt (interest payments/total debt) for 2010 at 6.9%, which corresponds to 10.5% for internal debt, 6.3% for external, and 4.6% for PDVSA. Last but not least, we calculate the external debt service ratio, ie, external debt service over total exports. Although the ratio almost doubled from 6.2% in 2008 to 13.4% in 2011, it is still considerably low, so we do not expect the capacity to pay to be an issue.

Venezuela will likely continue to generate current account surpluses

We expect current account surpluses of USD15.3bn in 2010 and USD15.0bn in 2011, due to a significant increase in oil prices, as well as a stabilization of imports at around USD40bn a year. The surpluses in the current account should be offset by similar deficits in the capital accounts of USD14.6bn and USD16.4bn in 2010 and 2011, respectively. We expect capital outflows to be led by the private sector, despite the FX restrictions that the authorities have imposed. Another important point is that for 2010-12, we do not expect any capital accumulation in the external sector from the public sector.

Figure 2: For 2011-12, we expect USD10bn per year in new issuance

	2008	2009	2010F	2011F	2012F
Total debt (USDbn)	60.5	76.6	96.2	112.0	124.8
Internal debt	12.0	14.5	22.1	25.1	29.9
External debt	48.5	62.2	74.1	86.9	94.9
Central government	29.9	35.1	36.8	39.6	44.9
PDVSA	15.1	21.5	24.9	27.5	33.0
Chinese fund	3.5	5.5	12.3	19.9	17.1
Total debt (% GDP)	23.0%	40.2%	47.1%	53.7%	53.9%
Internal debt (% GDP)	4.6%	7.6%	10.8%	12.0%	12.9%
External debt (% GDP)	18.5%	32.6%	36.3%	41.6%	41.0%
GDP (USDbn)	262.6	190.5	204.3	208.8	231.4
External debt services/exports	6.2%	7.4%	10.3%	13.4%	7.4%

Source: BCV, MF, PDVSA, Barclays Capital

Positive carry trade

We highlight two things. First, in the past, authorities have often bought Venezuelan and PDVSA bonds when their valuations reached these levels – the yield of the PDVSA 15 reached a peak of 20% in the past 12 months. Second, although we expect private issuance in mid-December, we think that the central bank will start to sell these bonds in 2011. In addition, we do not expect new issuance in the first quarter of the year and likely not in the

first semester. Under this framework, we recommend that investors build positions in Venezuela. Basically, we do not think the issuing spree will offset the positive effects of the expected devaluation in 1Q11, possible additional fiscal measures, the country's capacity to pay, and the likelihood of a brighter political outlook.

For investors that are not confortable with a long/overweight bond position, we suggest an inexpensive hedging strategy, basically buying 5y Venezuelan CDS. As a Simple example with the low dollar price bonds, assuming that the international law bonds and the PDVSA local law bonds have recovery values of around 35% and 15%, respectively. Basically, the recommendation is to buy 5y CDS for the difference between the market price and the recovery value. Although PDVSA 15 has a lower recovery value and the highest necessity to hedge, its Z-spread of nearly 18.0% makes it the potentially most profitable recommendation. For similar trades, we recommend *Venezuela: Assessing risk and how to hedge it (if you really want to)*, February 24, 2010, and *Venezuela: Brighter political outlook, higher recovery value*, March 17, 2010.

Figure 3: Venezuela: Macroeconomic Forecasts

	2007	2008	2009	2010F	2011F	2012F
Activity						
Real GDP (% y/y)	8.4	4.8	-3.3	-1.6	2.1	3.6
Oil GDP (% y/y)	-4.2	2.5	-7.2	-2.5	1.6	2.0
Non-Oil GDP (% y/y)	9.5	5.1	-2.0	-1.4	2.1	3.7
Consumption (% y/y)	16.1	7.0	-2.2	-1.9	2.4	3.8
Fixed Capital Investment (% y/y)	25.4	-3.3	-8.2	-4.1	3.0	5.4
Exports (% y/y)	-5.6	-2.7	-19.6	-14.0	-1.9	3.4
Imports (% y/y)	33.6	3.8	-19.7	-8.0	3.1	6.1
GDP (USD bn)	177.0	262.6	190.5	204.3	208.8	231.4
External Sector						
Oil Price (Brent, USD/bl.)	72.6	98.5	62.6	78.0	85.0	105.0
Current Account (USD bn)	20.0	38.9	8.6	15.3	15.0	22.8
CA (% GDP)	11.3	14.8	4.5	7.5	7.2	9.8
Trade Balance (USD bn)	23.7	47.0	19.2	27.0	27.9	36.9
Gross External Debt (USD bn)	43.9	48.5	62.2	74.1	86.9	94.9
International Reserves (USD bn)	33.5	43.0	35.0	35.7	34.3	26.7
Public Sector						
Public Sector Balance (% GDP)	-2.9	-2.7	-8.2	-1.3	-1.2	-3.7
Primary Balance (% GDP)	-1.3	-1.2	-6.7	0.2	0.5	-2.2
Gross Public Debt (% GDP)	31.4	21.8	38.8	47.1	53.7	53.9
Net Public Debt (% GDP)	5.9	2.1	14.3	18.8	25.2	29.4
Prices						
CPI (% Dec/Dec)	22.5	30.9	25.1	27.5	24.8	23.5
Offc Exchange Rate (VEF/USD, eop)	2.15	2.15	2.15	4.30	5.00	5.00
Avg Weighted Exch Rate (VEF/USD)	2.75	2.54	3.68	4.20	5.15	5.97
	1yr Ago	**Last**	**10Q4F**	**11Q1F**	**11Q2F**	**11Q3F**
Real GDP (y/y)	-4.6	-0.4	0.8	1.7	1.5	2.1
Offc Exchange Rate (VEF/USD, eop)	2.15	4.30	4.30	5.00	5.00	5.00

Source: BCV, Ministry of Finance, INE, Barclays Capital

OVERVIEW OF KEY ECONOMIC AND FINANCIAL INDICATORS

	2010 GDP	2010 population	2010 GDP	2010 GDP	2010 Share of world	Real GDP growth	Inflation	2010 Inflation Target	2011 Inflation Target	Sovereign credit rating			2010 Reserves	2010 Gross External Debt	2010 Gross Public Debt	2010 Saving Rate	2010 Openness
	(USD bn)	(mn)	(USD pc)	(PPP pc)	GDP at PPP	(2000-2010)	(2000-2010)	(%)	(%)	Moody's	S&P	Fitch	(USD bn)	(% GDP)	(% GDP)	(% GDP)	((X+M)/GDP)
PR China	5,866	1351.5	4,340	7,210	12.73	10.3	2.0	3.0	4.0	Aa3	A+	A+	2800	9	21	51	50
Hong Kong, SAR	230	7.1	32,644	44,379	0.44	4.4	0.1	N/A	N/A	Aa1	AA+	AA+	276	301	0.6	32	380
China, Taipei	432	23.2	18,670	31,119	1.07	3.4	1.0	0%	0-2%	Aa3	AA-	A+	395	21	34	32	116
India	1,570	1181.2	1,329	3,125	5.09	7.1	5.2	-	-	Baa3	BBB-	BBB-	305	17	80	29	41
Indonesia	702	242.9	2,889	4,356	1.36	5.1	8.4	4-6%	3.0-5.0%	Ba2	BB	BB+	92	28	26	31	46
Malaysia	240	28.3	8,503	13,869	0.58	4.8	2.2	-	-	A3	A-	A-	110	31	51	36	172
Philippines	189	94.0	2,013	3,635	0.47	4.6	5.2	2.5-4.5%	3.5-5.5%	Ba3	BB	BB	57	30	67	20	62
Singapore	227	5.1	44,661	51,352	0.35	5.1	1.5	-1.0%	2-3%	Aaa	AAA	AAA	225	62	91	54	385
South Korea	1,010	48.7	20,726	29,160	1.86	4.4	3.1	2.5-3.5%	2.0-4.0%	A1	A	A+	302	41	33	39	95
Thailand	310	64.2	4,832	8,339	0.83	4.1	2.4	0.0-3.5%	0.5-3.0%	Baa1	BBB+	BBB	173	29	42	33	126
Vietnam	102	87.3	1,168	3,099	0.36	7.3	7.1	-	-	Ba3	BB	B+	15	41	52	29	138
Emerging Asia	**10,878**	**3,133**	**3,472**	**10,191**	**25.1**	**8.0**	**3.1**						**4,750**				
Czech Republic	225	10.4	21,635	25,088	0.39	3.2	2.5	1%-3%	1%-3%	A1	A	A+	47	36	35	22	107
Hungary	127	10.0	12,700	18,686	0.27	2.2	5.5	3%	3%	Baa3	BBB-	BBB	43	130	79	23	146
Kazakhstan	137	15.6	8,773	11,762	0.26	8.1	8.4	-	-	Baa2	BBB-	BBB-	30	90	16	33	62
Poland	487	38.1	12,782	18,673	0.96	3.8	2.7	1.5%-3.5%	1.5%-3.5%	A2	A-	A-	97	63	55	21	68
Ukraine	135	45.5	2,971	6,786	0.48	4.3	10.9	-	-	B2	B+	B	34	85	37	15	76
Russia	1,506	140.4	10,725	15,617	3.35	4.7	11.9	-	-	Baa1	BBB	BBB	495	33	8	23	42
Turkey	735	71.4	10,294	12,849	1.35	3.8	16.4	6.5%	5.5%	Ba2	BB	BB+	81	37	43	13	41
South Africa	363	49.3	7,369	10,177	0.72	3.6	6.1	3-6%	3-6%	A3	BBB+	BBB+	43	28	37	16	46
EMEA	**3,715**	**381**	**9,759**	**14,922**	**7.8**	**4.3**	**10.2**						**870**				
Argentina	423	40.1	10,549	14,419	0.82	3.4	22.1	-	-	B2	B	B	53	37	49	21	30
Brazil	2,007	193.3	10,383	10,882	2.89	3.7	6.6	4.5%	4.5%	Baa3	BBB-	BBB-	291	13	67	16	19
Chile	204	17.1	11,956	14,922	0.36	3.8	3.1	3%	3%	Aa3	A+	A	27	42	9	23	60
Colombia	291	45.5	6,391	8,406	0.58	3.9	5.4	5%	3%	Ba1	BB+	BB+	28	22	38	20	26
Mexico	1,035	108.4	9,551	14,056	2.20	1.6	4.5	3%	3%	Baa1	BBB	BBB	112	21	34	20	57
Peru	155	29.6	5,232	9,223	0.38	5.2	2.5	2%	2%	Ba3	BBB-	BBB-	46	23	22	21	42
Uruguay	40	3.5	11,498	13,634	0.06	2.6	8.9	7%-3%	6%-4%	Ba3	BB+	BB	9	41	61	18	50
Venezuela	204	28.2	7,244	12,388	0.51	3.9	21.3	-	-	B2	BB-	BB-	36	36	47	12	51
Latin America	**4,360**	**466**	**9,362**	**12,084**	**7.8**	**3.2**	**8.1**						**602**				
Emerging Markets	**18,954**	**3,980**	**4,762**	**11,458**	**40.7**	**6.4**	**5.4**						**6,221**				

Source: Barclays Capital

GLOBAL FORECASTS

	Real GDP % over previous period, saar							Real GDP % annual chg			Consumer prices % over a year ago			
	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	2010F	2011F	2012F	2Q10	4Q10	2Q11	4Q11
Global	5.4	4.9	4.4	3.6	4.0	4.1	4.8	4.9	4.2	4.4	2.5	2.7	2.8	2.6
Developed	3.3	2.7	2.4	2.0	2.0	2.3	2.8	2.5	2.3	2.7	1.4	1.4	1.6	1.5
Emerging	8.1	7.6	6.9	5.7	6.4	6.3	7.2	7.8	6.5	6.6	5.3	5.9	5.8	5.3
BRIC	9.4	7.4	9.5	6.4	7.9	7.4	8.7	8.8	7.8	7.9	4.4	5.1	5.0	4.2
America	4.4	3.3	2.4	3.2	3.1	3.3	3.6	3.7	3.2	3.6	2.9	2.6	2.8	2.9
United States	3.7	1.7	2.5	3.0	2.5	3.0	3.5	2.8	2.8	3.6	1.8	1.2	1.5	1.5
Canada	5.6	2.3	1.0	2.5	2.5	2.5	2.5	2.9	2.3	2.5	1.4	2.3	2.1	2.1
Latin America	5.9	7.9	2.5	3.7	4.8	4.3	4.1	6.1	4.3	4.0	8.2	8.6	8.3	8.9
Argentina	13.4	12.3	0.8	5.5	6.5	5.0	4.5	8.9	5.3	4.0	22.5	25.2	26.8	28.0
Brazil	11.3	5.1	1.4	4.7	5.6	4.5	4.4	7.5	4.5	4.4	4.8	5.7	5.8	6.3
Chile	-5.2	19.5	8.1	4.0	5.0	5.0	5.0	5.4	6.1	4.5	1.2	2.4	1.6	3.0
Colombia	3.3	3.9	4.0	4.5	4.5	4.5	4.3	4.2	4.3	4.1	2.1	2.5	2.9	3.3
Mexico	-0.2	9.5	3.0	1.5	3.5	3.5	3.0	5.1	3.2	3.0	4.0	4.3	4.0	4.2
Peru	8.5	11.5	7.7	8.3	7.2	7.2	7.0	8.9	7.7	6.8	1.6	2.3	2.4	2.5
Venezuela	-2.5	4.7	0.8	0.4	1.5	2.9	3.6	-1.6	2.1	3.6	31.3	27.5	23.7	24.8
Asia/Pacific	9.7	6.4	7.7	4.9	6.2	6.4	7.7	7.9	6.4	6.7	2.2	2.8	2.9	2.2
Japan	6.6	1.8	4.1	-1.9	1.2	1.0	2.5	3.5	1.2	1.6	-1.2	-0.6	-0.1	-0.4
Australia	2.7	4.5	0.8	3.2	3.7	4.4	3.5	2.7	3.4	3.8	2.7	2.5	2.5	2.6
Emerging Asia	10.7	7.6	8.9	6.7	7.5	7.7	9.1	9.2	7.8	8.1	4.1	4.8	4.6	3.6
China	9.4	8.0	10.3	9.5	9.1	8.7	10.0	10.2	9.3	9.2	2.9	4.6	4.7	3.1
Hong Kong	8.7	5.7	2.8	2.4	6.1	4.9	5.3	6.6	4.6	4.0	2.6	3.3	3.6	2.5
India	13.5	8.6	16.3	1.0	8.2	8.2	11.0	8.9	8.5	9.0	10.6	7.4	5.6	6.4
Indonesia	5.4	6.4	4.7	9.5	5.3	4.1	8.7	6.0	6.5	6.7	5.0	6.5	6.6	6.0
Korea	8.8	6.0	2.9	1.7	4.8	5.7	3.8	6.1	4.0	4.5	2.6	4.0	2.9	1.9
Malaysia	7.5	4.7	-2.7	6.0	7.7	7.0	6.0	7.5	5.5	6.0	1.6	2.0	2.7	2.3
Philippines	14.6	9.7	2.4	4.9	4.1	7.8	3.6	7.0	5.0	5.6	3.9	3.0	3.8	3.3
Singapore	45.6	27.3	-18.7	9.2	4.0	7.4	7.3	15.0	4.0	6.5	3.1	3.8	2.9	1.7
Sri Lanka	2.8	12.6	7.4	7.4	-0.8	12.6	7.4	7.5	6.8	7.0	4.8	7.5	11.0	8.7
Taiwan	17.3	1.9	0.1	4.7	5.1	3.9	5.0	10.3	4.0	4.5	1.1	1.0	1.5	1.6
Thailand	15.1	-2.3	-0.9	4.5	5.1	5.1	6.1	8.0	4.0	6.0	3.2	2.9	2.6	3.3
Vietnam	-6.5	11.3	11.2	17.8	-13.9	12.8	18.7	6.8	7.2	7.5	8.7	11.5	15.0	12.0
Europe and Africa	1.3	4.9	2.6	2.6	2.2	2.1	2.5	2.5	2.5	2.5	2.4	2.8	2.8	2.7
Euro area	1.5	4.0	1.6	1.9	1.7	1.8	2.2	1.7	2.0	1.9	1.5	2.0	1.9	1.9
United Kingdom	1.8	3.9	3.1	2.6	1.0	1.7	1.7	1.6	2.0	2.1	3.4	3.2	3.3	3.0
Sweden	6.9	8.4	8.7	2.4	2.8	2.8	2.8	5.2	3.8	2.8	1.0	1.4	1.7	1.7
EM Europe & Africa	0.4	7.2	4.4	4.2	4.0	3.2	3.5	4.3	3.9	4.1	5.3	6.3	6.2	6.0
Czech Repub.	1.5	3.8	4.4	2.3	3.1	3.1	3.7	2.5	3.3	3.4	1.2	2.1	1.9	2.2
Hungary	2.4	0.0	0.3	0.6	1.5	2.0	3.0	1.2	3.1	3.7	5.4	4.1	4.1	3.0
Poland	-5.3	9.3	7.7	4.9	4.1	0.3	2.0	3.8	4.0	4.3	2.3	2.8	3.0	3.0
Russia	0.4	5.2	2.7	4.2	4.3	3.8	3.8	3.8	3.8	4.0	5.8	8.5	8.4	7.2
Turkey	1.8	15.5	7.8	4.5	4.3	3.9	3.7	8.1	4.7	4.3	8.4	7.1	6.6	8.0
South Africa	4.6	2.8	2.6	4.7	3.6	3.6	3.6	2.8	3.6	3.9	4.2	3.7	4.2	5.0

All EMEA quarterly GDP forecasts except South Africa reported in terms y/y%.

WORLD AT A GLANCE

	CPI inflation (% change)					Current account (% GDP)				
	2008	2009	2010F	2011F	2012F	2008	2009	2010F	2011F	2012F
Global	4.6	0.9	2.4	2.6	2.5	-1.0	-0.2	-0.7	-1.3	-1.4
Developed	3.3	0.0	1.4	1.6	1.6	-2.2	-1.1	-1.5	-2.0	-2.1
Emerging	7.8	2.9	4.9	5.1	4.9	1.8	2.1	1.0	0.5	0.2
BRIC	6.8	1.4	4.8	5.1	4.9	5.1	3.1	2.3	2.0	1.6
America	4.9	1.1	2.9	2.9	3.1	-3.6	-2.2	-3.0	-3.8	-4.2
United States	3.8	-0.4	1.6	1.5	1.8	-4.9	-2.7	-3.6	-4.6	-5.2
Canada	2.4	0.3	1.8	2.1	2.2	0.5	-2.7	-2.8	-2.7	-2.4
Latin America	10.1	7.2	8.2	8.7	8.4	0.1	-0.1	-0.6	-1.0	-1.1
Argentina	26.7	16.3	22.1	26.9	28.0	2.3	3.8	1.4	0.0	-0.6
Brazil	5.9	4.3	5.7	6.3	5.5	-1.7	-1.5	-2.5	-2.9	-3.1
Chile	8.7	1.5	1.4	2.2	3.4	-1.5	2.6	-0.9	2.7	0.7
Colombia	7.0	4.2	2.2	3.2	3.2	-2.8	-2.0	-2.4	-2.6	-2.1
Mexico	5.1	5.3	4.2	4.1	3.8	-1.5	-0.7	-0.4	-1.2	-1.5
Peru	6.7	0.3	2.3	2.5	2.3	-3.7	0.2	-1.4	-3.3	-3.8
Venezuela	30.9	25.1	27.5	24.8	23.5	14.8	4.5	7.5	7.2	9.8
Asia/Pacific	4.7	0.1	2.3	2.7	2.6	4.2	3.8	3.4	2.7	2.2
Japan	1.5	-1.3	-1.0	-0.3	-0.2	3.2	2.8	3.5	2.3	1.9
Australia	4.4	2.9	2.7	2.9	2.8	-5.5	-3.2	-3.0	-2.6	-2.8
Emerging Asia	6.6	0.6	4.1	4.3	4.1	5.8	5.1	4.0	3.5	3.0
China	5.9	-0.7	3.3	4.3	4.0	9.4	6.0	5.3	4.8	4.3
Hong Kong	4.3	0.5	2.5	3.3	3.0	13.7	8.7	8.2	8.2	8.0
India	8.7	2.2	9.1	5.9	6.7	-3.4	-2.5	-4.0	-3.0	-3.1
Indonesia	10.3	4.3	5.2	6.3	5.8	0.1	2.0	1.1	0.5	0.1
Korea	4.7	2.8	3.0	2.7	1.6	-0.6	5.1	3.2	1.7	1.2
Malaysia	5.4	0.6	1.7	2.5	2.2	17.5	16.4	10.5	13.7	9.9
Philippines	9.3	3.2	3.9	3.6	3.4	2.1	5.4	5.7	6.6	5.9
Singapore	6.6	0.6	2.8	2.6	2.0	18.5	17.7	19.7	16.2	13.1
Sri Lanka	22.8	3.6	6.0	9.6	7.4	-10.1	-0.5	-3.0	-2.8	-2.7
Taiwan	3.5	-0.9	0.9	1.6	2.2	6.9	11.4	8.7	5.7	6.0
Thailand	5.5	-0.8	3.3	2.9	2.5	0.6	8.3	4.0	3.1	1.5
Vietnam	23.0	7.0	9.2	13.2	9.7	-11.6	-8.0	-8.9	-8.2	-7.1
Europe and Africa	3.5	0.7	1.9	2.2	1.8	-1.6	-0.7	-1.0	-1.0	-0.6
Euro area	3.3	0.3	1.6	2.0	1.7	-1.5	-0.6	-0.6	-0.7	-0.4
United Kingdom	3.6	2.2	3.2	3.2	1.8	-1.6	-1.3	-2.8	-2.1	-1.0
EM Europe & Africa	8.2	4.0	3.9	3.9	3.8	-3.6	-1.3	-2.8	-3.3	-3.6
Czech Republic	6.0	1.1	1.5	2.1	2.0	-3.1	-1.1	-2.6	-3.3	-3.5
Hungary	6.1	4.3	4.8	3.9	3.4	-6.9	-0.4	0.9	0.3	-0.5
Poland	4.1	3.5	2.5	3.1	2.9	-4.7	-2.3	-3.0	-3.0	-3.1
Russia	14.1	11.7	6.9	8.0	6.9	6.1	3.9	4.4	2.8	2.1
Turkey	10.2	6.3	8.4	6.5	6.4	-5.7	-2.3	-6.0	-5.9	-6.0
South Africa	11.5	7.1	4.3	4.3	5.1	-7.1	-4.1	-3.3	-3.6	-4.2

IMF weight of real GDP using PPP (2008) for real GDP; nominal GDP (2008) for CPI inflation.
Source: Barclays Capital

OFFICIAL INTEREST RATES

Official rate	Current	Start of cycle		Last move	Next move expected	Forecasts as at end of			
		Date	Level			Q4 10	Q1 11	Q2 11	Q3 11
% per annum (unless stated)									
Advanced									
Fed funds rate	0-0.25	Easing: 17 Sep 07	5.25	Dec 08 (-75-100)	Aug 12 (+25)	0-0.25	0-0.25	0-0.25	0-0.25
BoJ overnight rate	0.10	Easing: 30 Oct 08	0.50	Dec 08 (-20)	Q1 13 (+20)	0.10	0.10	0.10	0.10
ECB repo rate	1.00	Easing: 8 Oct 08	4.25	May 09 (-25)	Q2 12 (+25)	1.00	1.00	1.00	100
Emerging Asia									
China: Working capital rate	5.56	Tightening: 19 Oct 10	5.56	Oct 10 (+25)	Dec 10 (+25)	5.81	6.06	6.31	6.31
Hong Kong: Base rate	0.50	Easing: 19 Sep 07	6.75	Dec 08 (-100)	Beyond 2011	0.50	0.50	0.50	0.50
India: Repo rate	6.25	Tightening: 19Mar 10	4.75	Nov10 (+25)	Q2 11 (+25)	6.25	6.25	6.50	6.75
Indonesia: O/N policy rate	6.50	Easing: 4 Dec 08	9.50	Aug 09 (-25)	Q2 11 (+25)	6.50	6.50	6.75	6.75
Korea: Base Rate	2.50	Tightening: 9 Jul 10	2.25	Nov 10 (+25)	Q1 11 (+25)	2.50	2.75	3.00	3.25
Sri Lanka: Reverse Repo	9.00	Easing: 20 Feb 09	12.00	Aug 10 (-50)	Q3 11 (+25)	9.00	9.00	9.25	9.50
Malaysia: O/N policy rate	2.75	Tightening: 04 Mar 10	2.75	Jul 10 (+25)	Q1 11 (+25)	2.75	3.00	3.25	3.25
Philippines: O/N lending	4.00	Easing: 18 Dec 08	6.00	May 09 (-25)	Q3 11 (+25)	4.00	4.00	4.00	4.25
Taiwan: Rediscount rate	1.50	Tightening: 24 Jun 10	1.375	Sep 10 (+12.5)	Q4 10(+12.5)	1.625	1.75	1.875	2.00
Thailand: O/N repo rate	2.00	Tightening: 14 Jul 10	1.50	Dec 10 (+25)	Q1 11 (+25)	2.00	2.25	2.50	2.50
Vietnam: Base rate	9.00	Tightening: 1 Dec 09	7.00	Nov 10 (+100)	Q1 11 (+100)	9.00	10.00	11.00	11.00
Emerging Europe and Africa									
Czech R: 2w repo rate	0.75	Easing: 8 Aug 08	3.75	Apr 10 (-25)	Apr 11 (+25)	0.75	1.00	1.50	2.00
Hungary: 2w deposit rate	5.50	Tightening: 29 Nov 10	11.50	Apr 10 (-25)	Jan 11 (+25)	5.50	6.00	6.00	6.00
Poland: 2w repo rate	3.50	Easing: 26 Nov 08	6.00	Jun 09 (-25)	Jan 11 (+25)	3.50	3.75	4.00	4.25
Romania: Key policy rate	6.25	Easing: 4 Feb 08	10.25	May 10 (-25)	beyond Q4-11	6.25	6.25	6.25	6.25
Russia: Refi rate	7.75	Easing: 24 Apr 09	13.00	Jun 10 (-25)	Feb 11 (+25)	7.75	8.25	8.50	8.50
South Africa: repo rate	5.50	Easing: 11 Dec 08	12.00	Nov 10 (-50)	Mar 12 (+50)	5.50	5.50	5.50	5.50
Turkey: 1wk repo rate	7.00	Easing: 20 Nov 08	16.75	Nov 09 (-25)	Sep-11 (+50)	7.00	7.00	7.00	7.50
Egypt: Deposit rate	8.25	Easing: 13 Feb 09	11.50	Sep 09 (-25)	Jun 11 (+25)	8.25	8.25	8.50	8.50
Israel: Discount Rate	2.00	Tightening: Aug 09	0.50	Sep 10 (+25)	Dec 10 (+25)	2.25	2.50	2.75	3.00
Latin America									
Brazil: SELIC rate	10.75	Tightening: 28 Apr 10	8.75	Jul 10 (+50)	Mar 11 (+50)	10.75	11.25	12.25	12.25
Chile: Monetary Policy Rate	3.00	Tightening: 15 Jun 10	0.50	Nov 10 (+25)	Dec 10 (+25)	3.25	4.00	4.00	4.00
Colombia Repo Rate	3.00	Easing: 19 Dec 08	10.0	Apr 10 (-50)	Sep 11 (+25)	3.00	3.00	3.00	3.25
Mexico: Overnight Rate	4.50	Easing: 16 Jan 09	8.25	Jul 09 (-25)	Jan 12 (+25)	4.50	4.50	4.50	4.50
Peru: Reference rate	3.00	Tightening: 6 May 10	1.25	Sep 10 (+50)	Mar 11 (+25)	3.00	3.25	3.50	3.75

Note: Changes denoted in bold.
Source: Barclays Capital

FX FORECASTS AND FORWARDS

Koon Chow, George Christou, Roberto Melzi, Kumar Rachapudi

	FX forecasts					Forecast vs. outright forward			
	Spot	1m	3m	6m	1y	1m	3m	6m	1y
G7 countries									
EUR	1.33	1.38	1.35	1.35	1.30	3.5%	1.3%	1.3%	-2.2%
JPY	83.0	80.0	82.0	85.0	89.0	-3.6%	-1.1%	2.6%	7.9%
GBP	1.58	1.60	1.61	1.64	1.67	1.2%	1.9%	3.9%	6.0%
CHF	0.98	0.97	1.02	1.04	1.12	-1.2%	4.0%	6.2%	14.6%
CAD	1.01	1.00	1.00	1.04	1.07	-0.7%	-0.8%	2.9%	5.3%
AUD	0.99	1.01	1.02	0.95	0.92	2.3%	4.1%	-1.9%	-2.7%
NZD	0.76	0.79	0.80	0.78	0.76	3.8%	5.6%	3.7%	2.7%
Emerging Asia									
CNY	6.65	6.631	6.575	6.490	6.324	-0.2%	-0.6%	-1.3%	-2.6%
HKD	7.76	7.76	7.77	7.78	7.80	0.0%	0.1%	0.3%	0.7%
INR	44.65	46.00	45.50	45.50	45.00	2.3%	0.3%	-1.0%	-4.2%
IDR	9003	9000	8900	9000	9200	-0.1%	-1.7%	-1.4%	-1.2%
KRW	1131	1100	1075	1075	1025	-3.0%	-5.4%	-5.5%	-7.8%
LKR	111.2	111.2	111.0	111.0	110.0	0.0%	-0.2%	-0.4%	na
MYR	3.14	3.05	3.03	2.99	2.92	-2.9%	-3.7%	-5.3%	-8.0%
PHP	43.59	43.50	42.00	41.50	40.00	0.1%	-3.2%	-4.3%	-7.7%
SGD	1.30	1.2900	1.2830	1.2790	1.2600	-1.1%	-1.6%	-2.0%	-3.4%
THB	30.03	30.00	29.75	29.50	29.00	-0.2%	-1.1%	-2.1%	-4.0%
TWD	30.11	30.00	29.00	28.50	28.00	-0.2%	-3.1%	-4.1%	-4.9%
VND	19496	19500	19800	19800	19800	-1.1%	-1.2%	-3.4%	-7.7%
Latin America									
ARS	3.98	4.00	4.06	4.15	4.30	0.2%	0.6%	0.6%	-1.1%
BRL	1.68	1.75	1.70	1.65	1.65	3.6%	-0.6%	-5.6%	-9.4%
CLP	476	495	480	465	465	3.8%	0.2%	-3.7%	-5.2%
MXN	12.39	12.70	12.40	12.20	12.20	2.3%	-0.5%	-3.1%	-5.0%
COP	1,884	1950	1920	1850	1850	4.1%	2.4%	-1.4%	-1.9%
PEN	2.82	2.84	2.83	2.78	2.75	0.7%	0.2%	-1.9%	-3.4%
EMEA									
EUR/CZK	24.99	25.00	25.00	24.20	23.90	0.0%	0.1%	-3.2%	-4.4%
EUR/HUF	278.91	279	280	280	272	-0.3%	-0.6%	-1.5%	-6.0%
EUR/PLN	4.01	4.00	4.00	3.90	3.90	-0.4%	-0.7%	-3.8%	-4.8%
EUR/RON	4.30	4.34	4.38	4.35	4.35	0.7%	1.1%	-0.6%	-2.7%
USD/RUB	31.21	31.3	30.8	30.8	31.1	0.0%	-2.1%	-3.0%	-4.3%
BSK/RUB	35.93	36.00	35.00	35.00	36.00	-0.3%	-3.4%	-4.3%	-3.4%
USD/TRY	1.48	1.50	1.47	1.45	1.45	1.1%	-1.7%	-4.3%	-7.0%
USD/ZAR	6.88	6.95	6.88	6.90	7.10	0.5%	-1.3%	-2.3%	-1.9%
USD/ILS	3.62	3.67	3.65	3.60	3.50	1.3%	0.7%	-0.9%	-4.0%
USD/EGP	5.78	5.80	5.82	5.92	5.96	-0.3%	-0.8%	-0.8%	-4.1%
USD/UAH	7.95	7.95	7.95	7.95	7.95	-0.3%	-1.8%	-3.5%	-6.2%

Source: Barclays Capital

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